VARIAN MEDICAL SYSTEMS INC
Form 10-Q
May 08, 2012
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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 March 30, 2012

or

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

For the transition period from ______to ______

Commission File Number 1-7598

VARIAN MEDICAL SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

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

(650) 493-4000

(Registrant s telephone number, including area code)

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

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

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

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

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 111,503,830 shares of common stock, par value $1 per share, outstanding as of April 27, 2012.

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VARIAN MEDICAL SYSTEMS, INC.

FORM 10-Q for the Quarter Ended March 30, 2012

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PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

(Unaudited)

	Three Months Ended		Six Months Ended	
(In thousands, except per share amounts)	**March 30, 2012**	**April 1, 2011**	**March 30, 2012**	**April 1, 2011**
Revenues:				
Product	$ 546,807	$ 498,743	$ 1,003,604	$ 930,537
Service contracts and other	173,467	149,712	342,008	297,770
Total revenues	720,274	648,455	1,345,612	1,228,307
Cost of revenues:				
Product	337,620	278,953	612,623	526,393
Service contracts and other	85,958	80,508	167,534	146,081
Total cost of revenues	423,578	359,461	780,157	672,474
Gross margin	296,696	288,994	565,455	555,833
Operating expenses:				
Research and development	47,067	43,873	90,832	82,375
Selling, general and administrative	105,830	93,924	201,905	185,234
Total operating expenses	152,897	137,797	292,737	267,609
Operating earnings	143,799	151,197	272,718	288,224
Interest income	1,109	809	2,259	1,438
Interest expense	(707)	(809)	(1,536)	(1,364)
Earnings from operations before taxes	144,201	151,197	273,441	288,298
Taxes on earnings	36,429	48,118	75,435	88,730
Net earnings	$ 107,772	$ 103,079	$ 198,006	$ 199,568
Net earnings per share basic	$ 0.96	$ 0.87	$ 1.76	$ 1.69
Net earnings per share diluted	$ 0.94	$ 0.86	$ 1.73	$ 1.66

Shares used in the calculation of net earnings per share:

Weighted average shares outstanding basic	112,354	117,959	112,282	117,896
Weighted average shares outstanding diluted	114,513	120,386	114,428	120,336

See accompanying notes to the condensed consolidated financial statements.

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands, except par values)	March 30, 2012	September 30, 2011 [(1)]
Assets		
Current assets:		
Cash and cash equivalents	$ 616,727	$ 564,457
Short-term investment	31,624	19,205
Accounts receivable, net of allowance for doubtful accounts of $6,935 at March 30, 2012 and $6,034 at September 30, 2011	637,402	635,153
Inventories	444,800	409,962
Prepaid expenses and other current assets	136,575	111,875
Deferred tax assets	113,142	113,965
Total current assets	1,980,270	1,854,617
Property, plant and equipment, net	282,239	285,894
Goodwill	214,547	212,452
Other assets	186,114	145,798
Total assets	$ 2,663,170	$ 2,498,761
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 142,635	$ 154,946
Accrued expenses	273,120	290,009
Product warranty	48,605	50,128
Deferred revenues	142,068	140,173
Advance payments from customers	339,859	299,380
Short-term borrowings	149,269	181,400
Current maturities of long-term debt	6,250	9,876
Total current liabilities	1,101,806	1,125,912
Long-term debt	6,250	6,250
Other long-term liabilities	119,131	122,708
Total liabilities	1,227,187	1,254,870
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; 111,805 and 112,344 shares issued and outstanding at March 30, 2012 and at September 30, 2011, respectively	111,805	112,344
Capital in excess of par value	570,138	500,922
Retained earnings	798,996	677,473
Accumulated other comprehensive loss	(44,956)	(46,848)

Total stockholders equity	1,435,983	1,243,891
Total liabilities and stockholders equity	$ 2,663,170	$ 2,498,761

(1) The condensed consolidated balance sheet as of September 30, 2011 was derived from audited financial statements as of that date, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

See accompanying notes to the consolidated financial statements.

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)	**Six Months Ended** March 30, 2012	April 1, 2011
Cash flows from operating activities:		
Net earnings	$ 198,006	$ 199,568
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Share-based compensation expense	25,139	26,104
Tax benefits from exercises of share-based payment awards	4,881	19,010
Excess tax benefits from share-based compensation	(6,144)	(17,486)
Depreciation	26,329	23,977
Amortization of intangible assets	1,716	1,573
Deferred taxes	(705)	6,546
Provision for doubtful accounts receivable	2,169	162
Loss (Income) on equity investment in affiliate	503	(4,213)
Other	(913)	(74)
Changes in assets and liabilities, net of effect of acquisitions:		
Accounts receivable	(25,788)	29,997
Inventories	(28,985)	(53,169)
Prepaid expenses and other current assets	(32,718)	(19,771)
Accounts payable	(13,192)	2,567
Accrued expenses	(24,446)	(28,857)
Deferred revenues	(1,272)	879
Product warranty	(1,526)	(4,070)
Advance payments from customers	40,523	28,955
Other long-term liabilities	(4,954)	(5,670)
Net cash provided by operating activities	158,623	206,028
Cash flows from investing activities:		
Purchases of property, plant and equipment	(22,225)	(38,639)
Investment in debt security	(12,419)	
Acquisition of businesses, net of cash acquired	(9,832)	(8,099)
(Increase) decrease in cash surrender value of life insurance	(2,201)	373
Note repayment from affiliate and other, net	3,360	606
Other, net	539	(2,061)
Net cash used in investing activities	(42,778)	(47,820)
Cash flows from financing activities:		
Repurchases of common stock	(75,399)	(238,000)
Equity forward contracts		(68,063)
Proceeds from issuance of common stock to employees	41,816	104,867
Excess tax benefits from share-based compensation	6,144	17,486
Employees taxes withheld and paid for restricted stock and restricted stock units	(4,374)	(9,326)
Net borrowings (repayments) under line of credit agreements	(30,793)	99,969
Repayments of bank borrowings	(3,626)	(135)
Other	(49)	

Net cash used in financing activities	(66,281)	(93,202)
Effects of exchange rate changes on cash and cash equivalents	2,706	(838)
Net increase in cash and cash equivalents	52,270	64,168
Cash and cash equivalents at beginning of period	564,457	520,221
Cash and cash equivalents at end of period	$ 616,727	$ 584,389

Supplemental information:

VMS common stock valued at $25 million was received in the six months ended March 30, 2012 upon settlement of the August 2011 Repurchase Agreement (see Note 12).

See accompanying notes to the condensed consolidated financial statements.

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

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

Basis of Presentation

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

Fiscal Year

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

Principles of Consolidation

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

Use of Estimates

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

Investments in Privately Held Companies

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

monitors these equity investments for impairment and makes appropriate reductions in carrying values if the Company determines that

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

impairment charges are required based primarily on the financial condition and near-term prospects of these companies. The Company did not have any impairment loss on equity investments in privately held companies during both the three and six months ended March 30, 2012 and April 1, 2011.

Reclassifications

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

Recent Accounting Pronouncements

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

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

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

In May 2011, the FASB amended ASC 820, Fair Value Measurement. This amendment is intended to result in convergence between GAAP and International Financial Reporting Standards requirements for measurement of and disclosures about fair value. This guidance clarifies the application of existing fair value measurements and disclosures, and changes certain principles or requirements for fair value measurements and disclosures. The adoption of this amendment in the second quarter of fiscal year 2012 affected the Company s disclosure only and did not have a material impact on the Company s consolidated financial position, results of operations or cash flows.

2. BALANCE SHEET COMPONENTS:

(in millions)	**March 30, 2012**	**September 30, 2011**
Short-term Investment:		
Corporate debt security:		

Amortized cost	$	31.6	$	19.2
Unrealized gain (loss)				
Fair value	$	31.6	$	19.2

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

The short-term investment, which represents a loan to California Proton Treatment Center, LLC (CPTC), is classified as available-for-sale corporate debt security. See Note 15, Variable Interest Entity. The Company did not sell any portion of its short-term investment during the three and six months ended March 30, 2012.

The components of inventories were as follows:

(In millions)	March 30, 2012	September 30, 2011
Inventories:		
Raw materials and parts	$ 226.6	$ 231.9
Work-in-progress	80.5	54.5
Finished goods	137.7	123.6
Total inventories	$ 444.8	$ 410.0

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

(In millions)	March 30, 2012	September 30, 2011
Other long-term liabilities:		
Long-term income taxes payable	$ 42.6	$ 44.8
Other	76.5	77.9
Total other long-term liabilities	$ 119.1	$ 122.7

3. FAIR VALUE

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

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

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

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

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

Assets/Liabilities Measured at Fair Value on a Recurring Basis

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

Type of Instruments (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 at March 30, 2012:				
Money market funds	$ 29.0	$	$	$ 29.0
Derivative assets		1.5		1.5
Option to purchase a company			1.4	1.4
Corporate debt security			31.6	31.6
Total assets measured at fair value	$ 29.0	$ 1.5	$ 33.0	$ 63.5
Liabilities at March 30, 2012:				
Contingent consideration	$	$	$ (5.0)	$ (5.0)
Total liabilities measured at fair value	$	$	$ (5.0)	$ (5.0)
Assets at September 30, 2011:				
Money market funds	$ 1.3	$	$	$ 1.3
Option to purchase a company			1.4	1.4
Corporate debt security			19.2	19.2
Total assets measured at fair value	$ 1.3	$	$ 20.6	$ 21.9
Liabilities at September 30, 2011:				
Contingent consideration	$	$	$ (0.1)	$ (0.1)
Total liabilities measured at fair value	$	$	$ (0.1)	$ (0.1)

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

	Fair Value Measurement Using			
Line Item in Consolidated Balance Sheet (In millions)	Quoted Prices in Active Markets for Identical Instruments (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Balance
Assets at March 30, 2012:				
Cash and cash equivalents	$ 27.9	$	$	$ 27.9
Short-term investment			31.6	31.6
Prepaid expenses and other current assets		1.5		1.5
Other assets	1.1		1.4	2.5
Total assets measured at fair value	$ 29.0	$ 1.5	$ 33.0	$ 63.5
Liabilities at March 30, 2012:				
Accrued liabilities	$	$	$ (0.4)	$ (0.4)
Other long-term liabilities			(4.6)	(4.6)
Total liabilities measured at fair value	$	$	$ (5.0)	$ (5.0)
Assets at September 30, 2011:				
Cash and cash equivalents	$ 0.2	$	$	$ 0.2
Short-term investment			19.2	19.2
Other assets	1.1		1.4	2.5
Total assets measured at fair value	$ 1.3	$	$ 20.6	$ 21.9
Liabilities at September 30, 2011:				
Other long-term liabilities	$	$	$ (0.1)	$ (0.1)
Total liabilities measured at fair value	$	$	$ (0.1)	$ (0.1)

The Company obtains Level 1 instrument valuations from quotes for transactions in active exchange markets involving identical assets.

The Company s valuation of its Level 2 instruments includes valuations obtained from quoted prices for identical assets in markets that are not active. In addition, the Company has elected to use the income approach to value its derivative instruments using standard valuation techniques

and Level 2 inputs, such as currency spot rates, forward points and credit default swap spreads. The Company s derivative instruments are short-term in nature, typically one month to twelve months in duration.

The Company measures the fair value of its Level 3 contingent consideration liabilities based on the income approach by using a Monte Carlo simulation model with key assumptions that include estimated sales units of an acquired business during the earn-out period and estimated discount rates corresponding to the periods of expected payments. The estimated sales units used in the Monte Carlo simulation model range from 69 to 193 units during the earn-out period. The estimated discount rates used range from 0.13% to 0.42%. If the estimated sales units were to increase or decrease during the earn-out period, the fair value of the contingent consideration would increase or decrease, respectively. If the estimated discount rates used were to increase or decrease, the fair value of the contingent consideration would decrease or increase, respectively.

The Company s Level 3 corporate debt security is valued based on the income approach using key assumptions that include estimated probabilities of default by the counterparty and the London Interbank Offered Rate (LIBOR). As of March 30, 2012, the estimated probability of default by the counterparty was 0%. If the probability of default were to increase, the fair value of the corporate debt security would decrease.

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

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

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

(In millions)	Corporate Debt Security	Contingent Consideration	Option to Purchase a Company
Balance at September 30, 2011	$ 19.2	$ (0.1)	$ 1.4
Purchases	6.1	(4.9)	
Balance at December 30, 2011	25.3	(5.0)	1.4
Purchases	6.3		
Balance at March 30, 2012	$ 31.6	$ (5.0)	$ 1.4

There were no transfers of assets or liabilities between fair value measurement levels during either the three and six months ended March 30, 2012 or the three and six months ended April 1, 2011. Transfers between fair value measurement levels are recognized at the end of the reporting period.

Fair Value of Other Financial Instruments

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

	Fair Value Measurement Using			
Type of Instruments (In millions)	**Quoted Prices in Active Markets for Identical Instruments (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**Total Balance**
At March 30, 2012:				
Bank deposits (included in Cash and cash equivalents)	$ 588.8	$	$	$ 588.8
Short-term borrowings		(149.3)		(149.3)
Long-term debt		(13.3)		(13.3)
At September 30, 2011:				
Bank deposits (included in Cash and cash equivalents)	$ 564.3	$	$	$ 564.3
Short-term borrowings		(181.4)		(181.4)
Long-term debt		(17.2)		(17.2)

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

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

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

4. FINANCING RECEIVABLES AND ALLOWANCE FOR CREDIT LOSSES

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

(In millions)	March 30, 2012	September 30, 2011
Accounts receivable with contractual maturities of more than one year:		
Gross amount	$ 30.8	$ 16.2
Allowance for doubtful accounts		
Net amount	$ 30.8	$ 16.2
Amount past due	$ 0.6	$ 1.2
Note receivable:		
Note receivable from related party	$ 5.4	$ 8.8
Total note receivable	$ 5.4	$ 8.8
Amount past due	$	$
Short-term investment:		
Total short-term investment[1]	$ 31.6	$ 19.2
Amount past due	$	$

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

During the three and six months ended March 30, 2012, the Company sold $2.3 million and $7.5 million, respectively, of accounts receivable with contractual maturities of more than one year. There was no activity in the allowance for doubtful financing receivable accounts during the three and six months ended March 30, 2012.

5. GOODWILL AND INTANGIBLE ASSETS

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

(In millions)	March 30, 2012	September 30, 2011
Intangible Assets:		
Acquired existing technology	$ 31.7	$ 26.0
Patents, licenses and other	21.8	19.6
Customer contracts and supplier relationship	10.5	10.4
Accumulated amortization	(45.5)	(43.7)
Net carrying amount	$ 18.5	$ 12.3

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

Amortization expense for intangible assets was $0.8 million for both the three months ended March 30, 2012 and April 1, 2011, respectively, and $1.7 million and $1.6 million for the six months ended March 30, 2012 and April 1, 2011, respectively. The Company estimates amortization expense on a straight-line basis for the remaining six months of fiscal year 2012, fiscal year 2013, fiscal year 2014, fiscal year 2015, fiscal year 2016 and thereafter, will be as follows (in millions): $1.5, $2.9, $2.0, $1.7 and $10.4, respectively.

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

(In millions)	Oncology Systems	X-ray Products	Other	Total
Balance at September 30, 2011	$ 130.5	$ 6.1	$ 75.9	$ 212.5
Acquisition of a business	2.5			2.5
Foreign currency translation adjustments			(0.5)	(0.5)
Balance at March 30, 2012	$ 133.0	$ 6.1	$ 75.4	$ 214.5

6. RELATED PARTY TRANSACTIONS

VMS has a 40% ownership interest in dpiX Holding LLC (dpiX Holding), a two-member consortium which has a 100% ownership interest in dpiX LLC (dpiX), a supplier of amorphous silicon based thin-film transistor arrays (flat panels) for the Company s X-ray Products digital image detectors and for its Oncology Systems On-Board Imager® (OBI), and PortalVision™ imaging products. In accordance with the dpiX Holding agreement, net losses were to be allocated to the members, in succession, until their capital accounts equaled zero, then to the members in accordance with their ownership interests. The dpiX Holding agreement also provided that net profits were to be allocated to the members, in succession, until their capital accounts equaled the net losses previously allocated, then to the members in accordance with their ownership interests.

The equity investment in dpiX Holding is accounted for under the equity method of accounting. When VMS recognizes its share of net profits or losses of dpiX Holding, profits or losses in inventory purchased from dpiX are eliminated until realized by VMS. VMS recorded a loss on the equity investment in dpiX Holding of $1.4 million in the three months ended March 30, 2012 and income of $2.0 million in the three months ended April 1, 2011. VMS recorded a loss on the equity investment in dpiX Holding of $0.5 million in the six months ended March 30, 2012 and income of $4.2 million in the six months ended April 1, 2011. Income and loss on the equity investment in dpiX Holding are included in Selling, general and administrative expenses in the Condensed Consolidated Statements of Earnings. The carrying value of the equity investment in dpiX Holding, which was included in Other assets in the Condensed Consolidated Balance Sheets, was $43.9 million at March 30, 2012 and $46.7 million at September 30, 2011.

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

During the three months ended March 30, 2012 and April 1, 2011, the Company purchased glass transistor arrays from dpiX totaling approximately $2.6 million and $5.6 million, respectively. Glass transistor arrays purchased from dpiX totaled approximately $8.0 million for

the six months ended March 30, 2012 and $12.2 million for the six months ended April 1, 2011. These purchases of glass transistor arrays are included as a component of Inventory in the Condensed Consolidated Balance Sheets and Cost of revenues product in the Condensed Consolidated Statements of Earnings for these periods.

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(Unaudited)

7. CREDIT FACILITY

As of March 30, 2012, VMS has a credit agreement with Bank of America, N.A. (BofA). As amended to date, the credit agreement with BofA provided for a revolving credit facility that enables the Company to borrow and have outstanding at any given time a maximum of $300 million (the Amended BofA Credit Facility). A portion of the Amended BofA Credit Facility was collateralized with a pledge of stock of certain of VMS s present and future subsidiaries that were deemed to be material subsidiaries. As of March 30, 2012, VMS had pledged to BofA 65% of the voting shares that it holds in Varian Medical Systems Nederland B.V., a wholly-owned subsidiary.

Under the Amended BofA Credit Facility, VMS s Japanese subsidiary (VMS KK) could borrow up to 2.7 billion Japanese yen as part of the overall credit facility (the Japanese Line of Credit). At any time amounts were outstanding under the Japanese Line of Credit, the full borrowing capacity was deemed committed for use in Japan and therefore the maximum amount VMS could otherwise borrow under the Amended BofA Credit Facility was reduced by $35 million to $265 million. VMS guarantees the payment of the outstanding balance under the Japanese Line of Credit. The Amended BofA Credit Facility, including the Japanese Line of Credit, terminated on April 27, 2012, and was replaced with a new credit agreement between VMS, certain lenders that are a party thereto, and BofA as administrative agent. At that time, the Company paid with a draw from the new credit facility the then outstanding balance of approximately $100 million under the Amended BofA Credit Facility. See Note 18, Subsequent Events.

The Amended BofA Credit Facility could be used for working capital, capital expenditures, permitted VMS share repurchases, permitted acquisitions and other lawful corporate purposes. Borrowings under the Japanese Line of Credit could be used by VMS KK for refinancing certain intercompany debts, working capital, capital expenditures and other lawful corporate purposes. Borrowings under the Amended BofA Credit Facility (outside of the Japanese Line of Credit) accrued interest either (i) based on the LIBOR plus a margin of 0.75% to 1.25% per annum 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 was greater, minus a margin of 0.5% to 0% per annum based on a leverage ratio involving funded indebtedness and EBITDA, depending upon the Company s instructions to BofA. The Company could 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 were adjustable daily. Under the Amended BofA Credit Facility, the Company paid commitment fees at an annual rate of 0.2% to 0.3% based on a leverage ratio involving funded indebtedness and EBITDA. Borrowings under the Japanese Line of Credit accrued interest at the basic loan rate announced by the Bank of Japan plus a margin of 1.25% to 1.50% per annum based on a leverage ratio involving funded indebtedness and EBITDA.

At March 30, 2012, a total of $125 million was outstanding under the Amended BofA Credit Facility with a weighted average interest rate of 0.99%, none of which was outstanding under the Japanese Line of Credit. At September 30, 2011, a total of $181 million was outstanding under the Amended BofA Credit Facility with a weighted average interest rate of 1.05%, none of which was outstanding under the Japanese Line of Credit. Up to $25 million of the Amended BofA Credit Facility could be used to support letters of credit issued on behalf of the Company, of which none were outstanding as of March 30, 2012 or September 30, 2011.

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

In addition, VMS KK has an unsecured uncommitted credit agreement with Sumitomo Mitsui Banking Corporation that enables VMS KK to borrow and have outstanding at any given time a maximum of 3 billion Japanese yen (the Sumitomo Credit Facility). The Sumitomo Credit Facility will expire on February 28, 2013. Borrowings under the Sumitomo Credit Facility accrue interest based on the basic loan rate announced by the Bank of Japan plus a margin of 0.5% per annum. As of March 30, 2012, 2 billion Japanese yen, or approximately $24.3 million, was outstanding under the Sumitomo Credit Facility with a weighted average interest rate of 0.67%.

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

8. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

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

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

	Asset Derivatives			Liability Derivatives		
(In millions)	Balance Sheet Location	March 30, 2012 Fair Value	September 30, 2011 Fair Value	Balance Sheet Location	March 30, 2012 Fair Value	September 30, 2011 Fair Value
Derivatives designated as hedging instruments:						
Foreign exchange forward contracts	Prepaid expenses and other current assets	$ 1.1	$	Accrued liabilities	$	$
Derivatives not designated as hedging instruments:						
Foreign exchange forward contracts	Prepaid expenses and other current assets	0.4		Accrued liabilities		
Total derivatives		$ 1.5	$		$	$

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

Cash Flow Hedging Activities

The Company has many transactions denominated in foreign currencies and addresses certain of those financial exposures through a risk management program that includes the use of derivative financial instruments. The Company sells products throughout the world, often in the currency of the customer s country, and may hedge certain of the larger foreign currency transactions when they are either not denominated in the relevant subsidiary s functional currency or the U.S. dollar. These foreign currency sales transactions are hedged using foreign currency forward contracts. The Company may use other derivative instruments in the future. The Company enters into foreign currency forward contracts primarily to reduce the effects of fluctuating foreign currency exchange rates. The Company does not enter into foreign currency forward contracts for speculative or trading purposes. The foreign currency forward contracts range from one to twelve months in maturity. As of March 30, 2012, the Company did not have any foreign currency forward contracts with an original maturity greater than twelve months.

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

Condensed Consolidated Statements of Earnings to offset changes in fair value of the resulting non-functional currency receivables. For derivative instruments that are designated and qualify as cash flow hedges under ASC 815, the Company formally documents for each

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derivative instrument at the hedge s inception the relationship between the hedging instrument (foreign currency forward contract) and hedged item (forecasted foreign currency revenues), the nature of the risk being hedged, as well as its risk management objective and strategy for undertaking the hedge. The Company records the effective portion of the gain or loss on the derivative instrument designated and qualify as cash flow hedges in Accumulated other comprehensive loss in the Condensed Consolidated Balance Sheets and reclassifies these amounts into Revenues in the Condensed Consolidated Statements of Earnings in the period during which the hedged transaction is recognized in earnings. The Company assesses hedge effectiveness both at the onset of the hedge and on an ongoing basis using regression analysis. The Company measures hedge ineffectiveness by comparing the cumulative change in the fair value of the effective component of the hedge contract with the cumulative change in the fair value of the hedged item. The Company recognizes any over performance of the derivative as ineffectiveness in Revenues, and amounts not included in the assessment of effectiveness in Cost of revenues in the Condensed Consolidated Statements of Earnings. During the three and six months ended March 30, 2012 and April 1, 2011, the Company did not discontinue any cash flow hedges. At the inception of the hedge, the Company assesses whether the likelihood of meeting the forecasted cash flow is highly probable. As of March 30, 2012, all forecasted cash flows were still probable to occur. As of September 30, 2011, net unrealized loss on derivative instruments before tax, of $11,000, was included in Accumulated other comprehensive loss in the Condensed Consolidated Balance Sheets. As of March 30, 2012, net unrealized gain on derivative instruments, before tax, of $1.1 million, was included in Accumulated other comprehensive loss, and is expected to be reclassified to earnings over the twelve months that follow.

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

(In millions)	Notional Value Sold March 30, 2012
Japanese yen	$ 17.0

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

	Gain (Loss) Recognized in Other Comprehensive Income (Effective Portion)				Location of Gain (Loss) Reclassified from Accumulated Other Comprehensive Income into Net Earnings (Effective Portion)	Gain (Loss) Reclassified from Accumulated Other Comprehensive Income into Net Earnings (Effective Portion)			
	Three Months Ended		Six Months Ended			Three Months Ended		Six Months Ended	
(In millions)	March 30, 2012	April 1, 2011	March 30, 2012	April 1, 2011		March 30, 2012	April 1, 2011	March 30, 2012	April 1, 2011
Foreign exchange contracts	$ 1.3	$	$ 1.2	$ (0.5)	Revenues	$ 0.2	$ (0.4)	$ 0.1	$ (1.0)

Balance Sheet Hedging Activities

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

recognized in Selling, general and administrative expenses in the Condensed Consolidated Statements of Earnings.

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(Unaudited)

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

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

	At March 30, 2012	
(In millions)	**Notional Value Sold**	**Notional Value Purchased**
Australian dollar	$ 27.8	$
Canadian dollar		3.2
Danish krona		3.1
Euro	158.2	0.3
Indian rupee	3.8	
Japanese yen	48.3	
New Zealand dollar	2.3	
Norwegian krone	5.4	
Singapore dollar	3.6	
Swedish krona	8.7	
Swiss franc		53.1
Totals	$ 258.1	$ 59.7

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

Location of Gain or (Loss) Recognized in Income on Derivative	**Amount of Gain or (Loss) Recognized in Net Earnings on Derivative Three Months Ended**		**Amount of Gain or (Loss) Recognized in Net Earnings on Derivative Six Months Ended**	
(In millions)	**March 30, 2012**	**April 1, 2011**	**March 30, 2012**	**April 1, 2011**
Selling, general and administrative expenses	$ 0.4	$ (7.8)	$ 2.1	$ (3.0)

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

Contingent Features

Certain of the Company s derivative instruments are subject to a master netting agreement which contains provisions that require the Company, in the event of a default, to settle the outstanding contracts in net liability positions by making settlement payments in cash or by setting off

amounts owed to the counterparty against any credit support or collateral held by the counterparty. The counterparty s right of set-off is not limited to the derivative instruments and applies to other rights held by the counterparty. Pursuant to the master netting agreement, an event of default includes the Company s failure to pay the counterparty under the derivative instruments, voluntary or involuntary bankruptcy, the Company s failure to repay an aggregate of $25 million or more in debts, and deterioration of creditworthiness of the surviving entity when the Company

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merges or transfers its assets or liabilities to another entity. As of March 30, 2012 and September 30, 2011, the Company did not have significant outstanding derivative instruments with credit-risk-related contingent features that were in a net liability position.

9. COMMITMENTS AND CONTINGENCIES

Product Warranty

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

	Six Months Ended	
(In millions)	**March 30, 2012**	**April 1, 2011**
Accrued product warranty, at beginning of period	$ 50.1	$ 53.2
Charged to cost of revenues	23.3	20.1
Actual product warranty expenditures	(24.8)	(23.2)
Accrued product warranty, at end of period	$ 48.6	$ 50.1

Other Commitments

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

In September 2011, the Company entered into a commercial agreement in which the Company agreed to resell a third party company s products. As part of that agreement, the Company agreed to make guaranteed prepayments of $67 million to that third party for orders of its products that the Company will resell to end-user customers. As of March 30, 2012, the Company had remaining guaranteed prepayment obligations of $14 million in fiscal year 2012 and $21 million in fiscal year 2013 under this commercial agreement.

Environmental Remediation Liabilities

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

The Company spent $0.2 million (net of amounts borne by VI and VSEA) during both the three months ended March 30, 2012 and April 1, 2011, on environmental cleanup costs, third-party claim costs, project management costs and legal costs. The Company spent $0.4 million (net of amounts borne by VI and VSEA) during both the six months ended March 30, 2012 and April 1, 2011 on such costs.

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(Unaudited)

Inherent uncertainties make it difficult to estimate the likelihood of the cost of future cleanup, third-party claims, project management and legal services for the CERCLA sites and one of the Company s past facilities. Nonetheless, as of March 30, 2012, the Company estimated that, net of VI s and VSEA s indemnification obligations, future costs associated with the CERCLA sites and this facility would range in total from $2.1 million to $9.3 million. The time frames over which these cleanup project costs are estimated vary, ranging from one year up to thirty years as of March 30, 2012. Management believes that no amount in that range is more probable of being incurred than any other amount and therefore accrued $2.1 million for these cleanup projects as of March 30, 2012. The accrued amount has not been discounted to present value due to the uncertainties that make it difficult to develop a single best estimate.

The Company believes it has gained sufficient knowledge to better estimate the scope and cost of monitoring, cleanup and management activities for its other past and present facilities. This, in part, is based on agreements with other parties and also cleanup plans approved by or completed in accordance with the requirements of the governmental agencies having jurisdiction. As of March 30, 2012, the Company estimated that the Company s future exposure, net of VI s and VSEA s indemnification obligations, for the costs at these facilities, and reimbursements of third party s claims for these facilities, ranged in total from $6.0 million to $37.7 million. The time frames over which these costs are estimated to be incurred vary, ranging from one year to thirty years as of March 30, 2012. As to each of these facilities, management determined that a particular amount within the range of estimated costs was a better estimate than any other amount within the range, and that the amount and timing of these future costs were reliably determinable. The best estimate within that range was $13.9 million at March 30, 2012. Accordingly, the Company has accrued $10.5 million for these costs, which represents the best estimate discounted at 4%, net of inflation. This accrual is in addition to the $2.1 million described in the preceding paragraph.

These amounts are only estimates of anticipated future costs. The amounts the Company will actually spend may be greater or less than these estimates, even as the Company believes the degree of uncertainty will narrow as cleanup activities progress. While the Company believes its reserve is adequate, as the scope of the Company s obligations becomes more clearly defined, the Company may modify the reserve, and charge or credit future earnings accordingly. Nevertheless, based on information currently known to management, and assuming VI and VSEA satisfy their indemnification obligations, management believes the costs of these environmental-related matters are not reasonably likely to have a material adverse effect on the consolidated financial statements of the Company in any one fiscal year.

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

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

Acquisition-Related Commitments/Obligations

When the Company acquired ACCEL Instruments GmbH (ACCEL, which has since changed its name to Varian Medical Systems Particle Therapy GmbH) in January 2007, ACCEL was involved in a contract-related lawsuit, which the Company settled by agreeing to perform certain commissioning services for a proton therapy system for a fixed-price contract (the

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Fixed-Price Contract). In the first quarter of fiscal year 2010, the Company entered into a new contract (the New Contract) to perform certain services for a fixed price. The balance of the loss accrual related to this contingency (the New Contract) was 0.9 million as of March 30, 2012. If the actual costs related to the contingency exceed the estimated amount or if the estimated loss increases, the variances will be recognized in the Consolidated Statements of Earnings in the periods in which these variances arise.

Other Matters

From time to time, the Company is a party to or otherwise involved in legal proceedings, claims and government inspections or investigations and other legal matters, both inside and outside the United States, arising in the ordinary course of its business or otherwise. These matters include, as of March 30, 2012, a patent infringement lawsuit initiated in 2007 by the University of Pittsburgh regarding the Company s Real-time Position Management technology. On or about December 21, 2011, the trial court presiding over the litigation entered a summary judgment order in the case finding that the Company s RPM technology was covered by some of the claims of the subject patent. The remaining issues in the litigation were then trifurcated by the trial court, and in the proceedings the jury found (i) that the Company willfully infringed the subject patent, (ii) that the Company is liable for approximately $37 million in actual damages and (iii) that the subject patent was valid. In an order dated April 25, 2012, the court enhanced damages by doubling them to approximately $74 million. In addition, the court assessed prejudgment interest to the damages award in the amount of approximately $13 million, damages for the period from the last time sales information was updated in the litigation, *i.e.*, March 2011, until judgment, which will be doubled, and attorneys fees in an amount to be determined. The court also ordered the Company to pay ongoing royalties at the rates found by the jury for sales after the date of judgment. The Company intends to appeal the findings against it and believes that it has valid reasons for the judgment to be reversed.

The Company accrues amounts, to the extent they can be reasonably estimated, that it believes are adequate to address any liabilities related to legal proceedings and other loss contingencies that the Company believes will result in a probable loss. As of March 30, 2012, the Company had accrued an aggregate of approximately $7 million of such losses with respect to ongoing proceedings, including the University of Pittsburgh proceeding. However, such matters are subject to many uncertainties and outcomes are not predictable with assurance. The Company is unable to estimate a range of reasonably possible losses in excess of the amounts accrued with respect to such matters. There can be no assurances as to whether the Company will become subject to significant additional claims and liabilities with respect to ongoing or future proceedings. If actual liabilities significantly exceed the estimates made, the Company s consolidated financial position, results of operations or cash flows could be materially adversely affected.

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(Unaudited)

10. RETIREMENT PLANS

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

(In thousands)	Three Months Ended March 30, 2012	Three Months Ended April 1, 2011	Six Months Ended March 30, 2012	Six Months Ended April 1, 2011
Defined Benefit Plans				
Service cost	$ 1,100	$ 894	$ 2,209	$ 1,768
Interest cost	1,347	1,227	2,691	2,427
Settlement gain			(161)	
Expected return on plan assets	(1,335)	(1,198)	(2,666)	(2,371)
Amortization of prior service cost	40	37	80	75
Recognized actuarial loss	621	513	1,242	1,026
Net periodic benefit cost	$ 1,773	$ 1,473	$ 3,395	$ 2,925
Post-Retirement Benefit Plans				
Interest cost	$ 55	$ 62	$ 110	$ 124
Amortization of prior service cost	1	1	2	2
Recognized actuarial loss	21	13	42	26
Net periodic benefit cost	$ 77	$ 76	$ 154	$ 152

The Company made contributions to the defined benefit plans of $6.5 million during the six months ended March 30, 2012. The Company currently expects total contributions to the defined benefit plans for fiscal year 2012 will be approximately $9.8 million. The Company made contributions to the post-retirement benefit plans of $0.3 million during the six months ended March 30, 2012. The Company currently expects total contributions to the post-retirement benefit plans for fiscal year 2012 will be approximately $0.5 million.

11. INCOME TAXES

The Company s effective tax rate was 25.3% for the three months ended March 30, 2012, compared to 31.8% in the same period of fiscal year 2011. For the six months ended March 30, 2012, the Company s effective tax rate was 27.6%, compared to 30.8% in the same period of fiscal year 2011. The decrease in the Company s effective tax rate was primarily due to a shift in the geographic mix of earnings towards jurisdictions with lower tax rates. The Company s effective income tax rate differs from the U.S. federal statutory rate primarily because the Company s foreign earnings are taxed at rates that are, on average, lower than the U.S. federal rate, and because the Company s domestic earnings are subject to state income taxes.

The total amount of unrecognized tax benefits did not change by a significant amount during the six months ended March 30, 2012; however, the amount of unrecognized tax benefits has increased as a result of positions taken during the current and prior years, and has decreased as a result of expirations of the statutes of limitation and audit settlements in various jurisdictions.

12. STOCKHOLDERS EQUITY

Stock Repurchase Program

During the three months ended March 30, 2012, the Company settled an accelerated share repurchase agreement executed on August 25, 2011 with BofA (the August 2011 Repurchase Agreement). Pursuant to the August 2011 Repurchase Agreement, the Company paid to BofA $250 million and BofA delivered 3,849,638 shares of VMS common stock, representing approximately 85% of the shares expected to be repurchased. The remaining $37.5 million, representing approximately 15% of the initial cash payment to BofA, was recorded as an equity forward contract, which was included in Capital in excess of par value in the Condensed Consolidated Balance Sheet at September 30, 2011 and March 30, 2012. Under the terms of the August 2011 Repurchase Agreement, the specific number of shares that the Company ultimately repurchased was to be based on the volume weighted average share price of VMS common stock during the repurchase

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

period, less a discount, such that the Company might be entitled to receive additional shares of VMS common stock from BofA or the Company might be required to deliver shares of VMS common stock or, at the Company s option, make a cash payment to BofA. The repurchase period ended in February 2012 and the Company received an additional 375,449 shares of VMS common stock upon the settlement of the August 2011 Repurchase Agreement. The market value of the shares received of $25 million was included in Capital in excess of par value as of March 30, 2012.

Including the 375,449 shares received upon the upon the settlement of the August 2011 Repurchase Agreement, the Company repurchased a total of 1,500,000 shares of VMS common stock during the six months ended March 30, 2012, all of which were repurchased in the three months ended March 30, 2012. During the six months ended April 1, 2011, the Company repurchased 3,547,474 shares of VMS common stock, all of which were repurchased in the three months ended April 1, 2011, including shares of VMS common stock repurchased under earlier accelerated share repurchase agreements. Aggregate cash payments in connection with accelerated share repurchase agreements, if any, and for shares repurchased in the open market totaled $75.4 million during the three and six months ended March 30, 2012. Aggregate cash payments for such transactions for the three and six months ended April 1, 2011 totaled $306.1 million. All shares that were repurchased have been retired.

In February 2011, the VMS Board of Directors authorized the repurchase of 12 million shares of VMS common stock through the end of fiscal year 2012. As of March 30, 2012, 5,933,718 shares of VMS common stock remained available for repurchase under this repurchase authorization. Shares may be repurchased in the open market, in privately negotiated transactions (such as the August 2011 and similar accelerated repurchase programs) or under Rule 10b5-1 share repurchase plans, and may be made from time to time or in one or more blocks.

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

Comprehensive Earnings

The components of comprehensive earnings are as follows:

	Three Months Ended		Six Months Ended	
(In thousands)	**March 30, 2012**	**April 1, 2011**	**March 30, 2012**	**April 1, 2011**
Net earnings	**$ 107,772**	**$ 103,079**	**$ 198,006**	**$ 199,568**
Other comprehensive income (loss), net of tax:				
Defined benefit pension and post-retirement benefit plans:				
Settlement loss			91	
Amortization of prior service cost included in net periodic benefit cost	35	34	71	68
Amortization of net actuarial loss included in net periodic benefit cost	516	414	1,029	827
	551	448	1,191	895
Unrealized gain on derivatives:				
Increase (decrease) in unrealized gain	841	(3)	774	(318)
Reclassification adjustments	(126)	222	(84)	625
	715	219	690	307
Currency translation adjustment	4,939	8,975	11	4,520
Other comprehensive income (loss)	**6,205**	**9,642**	**1,892**	**5,722**
Total comprehensive earnings	**$ 113,977**	**$ 112,721**	**$ 199,898**	**$ 205,290**

13. EMPLOYEE STOCK PLANS

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

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

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

	Three Months Ended		Six Months Ended	
(In thousands, except per share amounts)	**March 30, 2012**	**April 1, 2011**	**March 30, 2012**	**April 1, 2011**
Cost of revenues Product	$ 1,247	$ 1,409	$ 2,244	$ 1,958
Cost of revenues Service contracts and other	405	438	867	1,218
Research and development	1,727	1,586	3,259	3,311
Selling, general and administrative	11,259	10,107	18,769	19,617
Taxes on earnings	(4,707)	(4,601)	(8,048)	(8,885)
Net decrease in net earnings	$ 9,931	$ 8,939	$ 17,091	$ 17,219
Increase (decrease) on:				
Cash flows from operating activities (1)	$ (4,917)	$ (8,250)	$ (6,144)	$ (17,486)
Cash flows from financing activities (1)	$ 4,917	$ 8,250	$ 6,144	$ 17,486

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

During the three and six months ended March 30, 2012, total share-based compensation expense recognized in earnings before taxes was $14.6 million and $25.1 million, respectively, and the total related recognized tax benefit was $4.7 million and $8.0 million, respectively. During the three and six months ended April 1, 2011, total share-based compensation expense recognized in earnings before taxes was $13.5 million and $26.1 million, respectively, and the total related recognized tax benefit was $4.6 million and $8.9 million, respectively.

Total share-based compensation expense capitalized as part of inventory for the three and six months ended March 30, 2012 was $0.9 million and $1.7 million, respectively. Total share-based compensation expense capitalized as part of inventory for the three and six months ended April 1, 2011 was $0.9 million and $1.7 million, respectively.

During the six months ended March 30, 2012, the Company granted performance units to certain employees under the Third Amended 2005 Plan (before and after its amendment and restatement). The number of shares of VMS common stock ultimately issued under the performance units at the end of a three-year performance period will depend on the Company s business performance during the three-year period against specified performance targets set by the Compensation and Management Development Committee of the Board of Directors at the beginning of the period. Subject to certain exceptions, any unvested performance unit awards are generally forfeited at the time of termination.

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

	Three Months Ended		Six Months Ended	
	March 30, 2012	**April 1, 2011**	**March 30, 2012**	**April 1, 2011**
Employee Stock Option Plans				
Expected term (in years)	4.77	4.69	4.64	4.69

Risk-free interest rate	0.8%	2.2%	0.8%	2.0%
Expected volatility	35.3%	35.6%	36.9%	35.6%
Expected dividend				
Weighted average fair value at grant date	$ 20.19	$ 23.80	$ 18.75	$ 23.26

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

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

	Three Months Ended		Six Months Ended	
	March 30, 2012	April 1, 2011	March 30, 2012	April 1, 2011
Employee Stock Purchase Plan				
Expected term (in years)	0.50	0.50	0.50	0.50
Risk-free interest rate	0.1%	0.2%	0.1%	0.2%
Expected volatility	20.4%	12.1%	21.9%	11.7%
Expected dividend				
Weighted average fair value at grant date	$ 12.20	$ 11.56	$ 12.49	$ 11.49

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

		Options Outstanding			
(In thousands, except per share amounts)	Shares Available for Grant	Number of Shares	Weighted Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (3)
Balance at September 30, 2011	8,424	6,917	$ 45.90		
Authorized	6,000				
Granted [1]	(2,641)	735	58.44		
Cancelled or expired [2]	27	(9)	54.54		
Exercised		(861)	41.10		
Balance at March 30, 2012	11,810	6,782	$ 47.85	4.0	$ 143,203
Exercisable at March 30, 2012		5,700	$ 46.22	3.6	$ 128,994

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

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

(3) The aggregate intrinsic value represents the total pre-tax intrinsic value, which is computed based on the difference between the exercise price and the closing price of VMS common stock of $68.96 as of March 30, 2012, the last trading date of the second quarter of fiscal year 2012, and which would have been received by the option holders had all option holders exercised and sold their options as of that date.

As of March 30, 2012, there was $14.5 million of total unrecognized compensation expense related to outstanding stock options. This unrecognized compensation expense is expected to be recognized over a weighted average period of 1.8 years.

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

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

(In thousands, except per share amounts)	Shares	Weighted Average Grant-Date Fair Value
Balance at September 30, 2011	735	$ 47.36
Granted	704	58.99
Vested	(203)	37.87
Cancelled or expired	(7)	53.15
Balance at March 30, 2012	1,229	$ 55.55

As of March 30, 2012, unrecognized compensation expense totaling $43.2 million was related to awards of restricted stocks, restricted stock units, deferred stock units and performance units. This unrecognized compensation expense is expected to be recognized over a weighted average period of 2.0 years.

14. EARNINGS PER SHARE

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

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

	Three Months Ended		Six Months Ended	
(In thousands, except per share amounts)	March 30, 2012	April 1, 2011	March 30, 2012	April 1, 2011
Net earnings	$ 107,772	$ 103,079	$ 198,006	$ 199,568
Weighted average shares outstanding basic	112,354	117,959	112,282	117,896
Dilutive effect of potential common shares	2,159	2,427	2,146	2,440
Weighted average shares outstanding diluted	114,513	120,386	114,428	120,336
Net earnings per share basic	$ 0.96	$ 0.87	$ 1.76	$ 1.69
Net earnings per share diluted	$ 0.94	$ 0.86	$ 1.73	$ 1.66

The Company excludes potentially dilutive common shares (consisting of shares underlying stock options and the employee stock purchase plan) from the computation of diluted weighted average shares outstanding if the per share value, either the exercise price of the awards or the sum of (a) the exercise price of the awards and (b) the amount of the compensation cost attributed to future services and not yet recognized and (c) the amount of tax benefit or shortfall that would be recorded in additional paid-in capital when the award becomes deductible, is greater than

the average market price of the shares, because the inclusion of the shares underlying these stock awards would be antidilutive to earnings per share.

Based on this calculation, stock options to purchase 743,646 shares at an average exercise price of $58.87 per share and 41,750 shares at an average exercise price of $69.79 per share were excluded from the computation of diluted weighted average shares outstanding for the three months ended March 30, 2012 and April 1, 2011, respectively. Stock options to purchase 249,798 shares at an average exercise price of $61.73 and 164,613 shares at an average exercise price of $56.67 per share were excluded from the computation of diluted weighted average shares outstanding for the six months ended March 30, 2012 and April 1, 2011, respectively.

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

15. VARIABLE INTEREST ENTITY

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

In April 2010, the Company signed an $88 million agreement to supply a proton therapy system to CPTC. The Company began recognizing revenues under this contract in the fourth quarter of fiscal year 2011. In June 2011, the Company signed a ten-year, approximately $60 million agreement with CPTC to service the proton therapy system. No revenues have been recognized under this service agreement. In addition, in September 2011, ORIX Capital Markets, LLC (ORIX) and the Company, through its Swiss subsidiary, committed to loan up to $165.3 million to CPTC. ORIX is the loan agent for this facility and, along with CPTC and Scripps, has budgetary approval authority for the Scripps Proton Therapy Center. The Company s maximum loan commitment under this facility is $115.3 million, reflecting the Company s pro rata share of 69.75% of the obligation to fund the initial distribution and subsequent advances. As of March 30, 2012, the Company had funded $31.6 million of its $115.3 million commitment, which is reported as a current asset on the Company s Condensed Consolidated Balance Sheets. The Company s subsidiary is not obligated to fund any additional amounts to CPTC beyond the $115.3 million committed under the loan facility. The Company may sell all or a portion of its participation in this loan facility before the end of the drawdown period in 2014. Upon the sale of all or a portion of this facility, the Company will not be required to make further loan advances for the portion of the facility that is sold.

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

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

As of March 30, 2012, in addition to the $31.6 million loan to CPTC, the Company had recorded $37.7 million in accounts receivable from CPTC. As of September 30, 2011, the outstanding loan balance to CPTC was $19.2 million and the accounts receivable balance from CPTC was $15.2 million. As of March 30, 2012, the Company s exposure to loss as a result of its involvement with CPTC was limited to the carrying amounts of these assets on its Condensed Consolidated Balance Sheets.

16. SEGMENT INFORMATION

The Company s operations are grouped into two reportable operating segments: Oncology Systems and X-ray Products. These reportable operating segments were determined based on how the Company s Chief Executive Officer, its Chief Operating Decision Maker (CODM), views and evaluates the Company s operations. The Company s Ginzton Technology Center (GTC), SIP business and Varian Particle Therapy (VPT) are reflected in the Other category because these operating segments do not meet the criteria of a reportable operating segment. The CODM

allocates resources to and evaluates the financial performance of each operating segment primarily based on operating earnings.

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

The following table summarizes selected operating results information for each business segment:

(In millions)	Three Months Ended March 30, 2012	Three Months Ended April 1, 2011	Six Months Ended March 30, 2012	Six Months Ended April 1, 2011
Revenues				
Oncology Systems	$ 566	$ 508	$ 1,053	$ 960
X-ray Products	123	117	236	229
Total reportable segments	$ 689	$ 625	$ 1,289	$ 1,189
Other	32	23	57	39
Total company	$ 721	$ 648	$ 1,346	$ 1,228
Operating Earnings (Loss)				
Oncology Systems	$ 125	$ 128	$ 237	$ 248
X-ray Products	33	28	60	58
Total reportable segments	$ 158	$ 156	$ 297	$ 306
Other	(9)	(5)	(19)	(13)
Corporate	(5)		(5)	(5)
Total company	$ 144	$ 151	$ 273	$ 288

17. BUSINESS COMBINATION

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

This business combination was not significant and therefore pro forma disclosures have not been presented.

18. SUBSEQUENT EVENTS

On April 3, 2012, VMS acquired InfiMed, Inc., a privately-held supplier of hardware and software for processing diagnostic X-ray images, for a cash payment of approximately $15 million plus potential contingent consideration upon achievement of certain milestones. This acquisition, which will be integrated into the Company s X-ray Products business, will enable the Company to provide more fully integrated X-ray component solutions to its customers.

In April 2012, VMS entered into a strategic global partnership with Siemens AG (Siemens) wherein, among other things, the Company will represent Siemens diagnostic imaging products to radiation oncology clinics initially in most international markets and expanding to North America and other markets later in the calendar year, and Siemens will represent the Company s equipment and software products for radiotherapy and radiosurgery within its offerings to its healthcare customers. Furthermore, the Company and Siemens will develop interfaces that will enable connecting the Company s ARIA® oncology information system software with Siemens linear accelerators and imaging systems, as well as co-develop new imaging and treatment solutions.

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

On April 27, 2012, VMS entered into a new, five-year credit agreement with certain lenders and BofA as administrative agent (the 2012 Credit Facility). The 2012 Credit Facility was arranged by Merrill Lynch, Pierce, Fenner & Smith Incorporated and enables the Company to borrow and have outstanding at any given time $300 million. The 2012 Credit Facility also includes a $50 million sub-facility for the issuance of letters of credit and permits swing line loans of up to $25 million. The Company also has the right to increase the aggregate commitments under the 2012 Credit Facility by up to $200 million, provided that the lenders are willing to provide increased commitments and certain other conditions are met. The 2012 Credit Facility is secured, subject to certain limitations on the amount secured, by a pledge of stock of certain of VMS s present and future subsidiaries that are deemed to be material subsidiaries. All hedging or treasury management obligations entered into by the Company with a lender are also secured by the stock pledges. The 2012 Credit Facility must be guaranteed by certain of VMS s material domestic subsidiaries under certain circumstances. The 2012 Credit Facility may be used for working capital, capital expenditures, permitted share repurchases, permitted acquisitions and other lawful corporate purposes.

Borrowings under the 2012 Credit Facility accrue interest either (i) based on a Eurodollar rate (as defined in the credit agreement), plus a margin of 1.25% to 1.5% based on a leverage ratio involving funded indebtedness and earnings before interest, taxes and depreciation and amortization (EBITDA) or (ii) based upon a base rate of the highest of (a) the federal funds rate plus 0.5%, (b) BofA s announced prime rate or (c) the Eurodollar rate plus 1%, plus a margin of 0.25% to 0.5% based on the same leverage ratio, depending on instructions from the Company. The Company also must pay a commitment fee on the unused portion of the 2012 Credit Facility at a rate from 0.25% to 0.50% based on the same leverage ratio. Swing line loans under the 2012 Credit Facility will bear interest at the base rate plus the then applicable margin for base rate loans. The Company may prepay, reduce or terminate the commitments without penalty. The credit agreement contains affirmative and negative covenants applicable to the Company that are typical for credit facilities of this type, and that are subject to materiality and other qualifications, carve-outs, baskets and exceptions. The Company has also agreed to maintain certain financial covenants, including (i) a maximum consolidated leverage ratio, involving funded indebtedness and EBITDA and (ii) a minimum cash flow coverage.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and

Stockholders of Varian Medical Systems, Inc.:

We have reviewed the accompanying condensed consolidated balance sheet of Varian Medical Systems, Inc. and its subsidiaries (the Company) as of March 30, 2012 and the related condensed consolidated statements of earnings for the three-month and six-month periods ended March 30, 2012 and April 1, 2011 and the condensed consolidated statements of cash flows for the six-month periods ended March 30, 2012 and April 1, 2011. These interim financial statements are the responsibility of the Company s management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

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

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

San Jose, CA

May 8, 2012

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations
Forward-Looking Statements

This Quarterly Report on Form 10 Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, which provides a safe harbor for statements about future events, products and future financial performance that are based on the beliefs of, estimates made by and information currently available to the management of Varian Medical Systems, Inc. (VMS) and its subsidiaries (collectively we, our or the Company). The outcome of the events described in these forward-looking statements is subject to risks and uncertainties. Actual results and the outcome or timing of certain events may differ significantly from those projected in these forward-looking statements or management s current expectations due to the factors cited in this Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A), the Risk Factors listed under Part II, Item 1A of this Quarterly Report on Form 10-Q, and other factors described from time to time in our other filings with the Securities and Exchange Commission (SEC), or other reasons. For this purpose, statements concerning: industry or market segment outlook; market acceptance of or transition to new products or technology such as fixed field intensity-modulated radiation therapy (IMRT), image-guided radiation therapy (IGRT), volumetric modulated arc therapy, stereotactic radiotherapy, stereotactic radiosurgery, brachytherapy, software, treatment techniques, proton therapy and advanced x-ray products; future events and developments, including expectations regarding acquisitions or partnerships; growth drivers; future orders, revenues, backlog, earnings or other financial results; and any statements using the terms believe, expect, expectation, anticipate, can, may, will, should, would, could, estimate, continue, grow, may, intended, potential, ongoing, likely, and possible or similar statements are fo statements. By making forward-looking statements, we have not assumed any obligation to, and you should not expect us to, update or revise those statements because of new information, future events or otherwise.

Overview

In the second quarter of fiscal year 2012, revenues increased 11% compared to the year-ago quarter. However, gross margin in the second quarter of fiscal year 2012 decreased 3.4 percentage points from the year-ago quarter due primarily to declines in Oncology Systems and SIP gross margins and revenues in our Varian Particle Therapy (VPT) business recognized at a zero margin, partially offset by an improvement in X-ray Products gross margin. Net earnings increased 5% and net earnings per diluted share increased 9% in the second quarter of fiscal year 2012 over the year-ago quarter, helped by a decrease in our effective tax rate. Net earnings per diluted share for the second quarter of fiscal 2012 included a restructuring charge associated with realigning our resources to address growth prospects in emerging markets. The number of weighted average shares outstanding on a diluted basis in the second quarter of fiscal year 2012 decreased from the year-ago quarter primarily due to repurchases of shares of VMS common stock.

All of our businesses reported growth in net orders in the second quarter of fiscal year 2012 from the year-ago quarter. VPT booked orders for two proton therapy systems in the second quarter of fiscal year 2012. Including $156 million in VPT backlog, our backlog at March 30, 2012 was 18% higher than at the end of the second quarter of fiscal year 2011.

In April 2012, we announced a strategic global partnership with Siemens AG (Siemens) to provide advanced diagnostic and therapeutic solutions and services for treating cancer with image-guided radiotherapy and radiosurgery.

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

Our primary goal in the Oncology Systems business is to promote the adoption of more advanced and effective cancer treatments. In our view, the fundamental market forces that drive long-term growth in our Oncology Systems business are the rising cancer incidence; technology advances and product developments that are leading to improvements in patient care; customer demand for the more advanced and effective cancer treatments that we offer; competitive conditions among hospitals and clinics to offer such advanced treatments; continued improvement in safety and cost efficiency in delivering radiation therapy; and underserved medical needs outside of the United States. We have recently seen a greater percentage of Oncology Systems net orders and revenues coming from emerging markets within our international region, such as China, Thailand, India and Russia, which typically demand lower-priced products compared to developed markets. We expect that this shift in geographic mix of net orders and revenues will generally continue and may negatively impact Oncology

Systems gross margin. A decision regarding the constitutionality of the Affordable Health Care for America Act is currently pending before the U.S. Supreme Court, and we do not know what impact that act, or any surviving portions of that act, will have on long-term growth or demand for our products and services.

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

Both the international region and North America contributed to the growth in Oncology Systems net orders and revenues in the second quarter of fiscal year 2012 over the second quarter of fiscal year 2011. Oncology Systems gross margin in the second quarter of fiscal year 2012 decreased from the second quarter of fiscal year 2011 primarily due to a significant geographic shift of product revenues away from high margin countries to lower margin countries within the international region. Our Oncology Systems product gross margin for the quarter was further impacted by stiffer pricing pressure.

Through March 30, 2012, we had received orders for about 490 TrueBeam systems since its introduction in the second quarter of fiscal year 2010 and had about 230 systems installed or in progress.

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

In the second quarter of fiscal year 2012, X-ray Products net orders increased over the year-ago quarter, with North American net orders partially offset by a decline in international net orders. Revenues in the second quarter of fiscal year 2012 increased compared to the second quarter of fiscal year 2011, with increases from both the international region and North America. Our key Japanese customers appear to have completed the inventory adjustments that slowed net orders and sales in the first quarter of fiscal year 2012. X-ray Products gross margin for the second quarter of fiscal year 2012 increased over the second quarter of fiscal year 2011 primarily due to lower costs of quality for our flat panel products, cost control measures and a product mix shift towards higher margin products.

On April 3, 2012, we acquired InfiMed, Inc., a supplier of hardware and software for processing diagnostic X-ray images, for a cash payment of approximately $15 million plus potential contingent consideration upon achievement of certain milestones. This acquisition will enable X-ray Products to provide more fully integrated X-ray component solutions to our customers.

Our success in our X-ray Products business depends upon our ability to anticipate changes in our markets, the direction of technological innovation and the demands of our customers. In addition, changes in access to diagnostic radiology or the reimbursement rates associated with diagnostic radiology as a result of the Affordable Health Care for America Act, should the relevant provisions of this act survive challenge in the U.S. Supreme Court, or as a result of similar state proposals, could affect demand for our products in our X-ray Products business.

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

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

VPT develops, designs, manufactures, sells and services products and systems for delivering proton therapy, another form of external beam radiotherapy using proton beams, for the treatment of cancer. Although proton therapy has been in clinical use for more than four decades, it has not been widely deployed due to high capital cost. Our current focus is commercializing our proton therapy system and bringing our expertise in traditional radiation therapy to proton therapy to improve its clinical utility and to reduce its cost of treatment per patient.

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

In the second quarter of fiscal year 2012, VPT recorded $124 million in net orders primarily for two proton therapy systems, one of which will be installed at the PTC St. Petersburg Center of Nuclear Medicine of the International Institute of Biological Systems in Russia and the other of which will be installed at the King Fahd Medical Center in Riyadh, Saudi Arabia. Increased demand for SIP products also contributed to the increase in net orders the Other category in the second quarter of fiscal year 2012 over the year-ago quarter. Revenues in our Other category increased in the second quarter of fiscal year 2012 from the year-ago quarter, primarily due to an increase in VPT product revenues partially offset by a decrease in SIP revenues.

This discussion and analysis of our financial condition and results of operations is based upon and should be read in conjunction with the Condensed Consolidated Financial Statements and the notes included elsewhere in this Quarterly Report on Form 10-Q and the Consolidated Financial Statements and the Notes to the Consolidated Financial Statements and the related Management s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended September 30, 2011 (the 2011 Annual Report), as well as the Risk Factors contained in Part II, Item 1A of this Quarterly Report on Form 10-Q, and other information provided from time to time in our other filings with the SEC.

Critical Accounting Estimates

The preparation of our financial statements and related disclosures in conformity with accounting principles generally accepted in the United States (GAAP) requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. These estimates and assumptions are based on historical experience and on various other factors that we believe are reasonable under the circumstances. We periodically review our accounting policies, estimates and assumptions and make adjustments when facts and circumstances dictate. In addition to the accounting policies that are more fully described in the Notes to the Consolidated Financial Statements included in our 2011 Annual Report, we consider the critical accounting policies described below to be affected by critical accounting estimates. Our critical accounting policies that are affected by accounting estimates include revenue recognition, share-based compensation expense, valuation of allowance for doubtful accounts, valuation of inventories, assessment of recoverability of goodwill and intangible assets, valuation of warranty obligations, assessment of environmental remediation liabilities, valuation of defined benefit pension and post-retirement benefit plans, valuation of derivative instruments and taxes on earnings. Such accounting policies require us to use judgments, often as a result of the need to make estimates and assumptions regarding matters that are inherently uncertain, and actual results could differ materially from these estimates. For a discussion of how these estimates and other factors may affect our business, see Part II, Item 1A, Risk Factors.

Revenue Recognition

We frequently enter into sales arrangements with customers that contain multiple elements or deliverables such as hardware, software and services. Judgments as to the allocation of consideration from an arrangement to the multiple elements of the arrangement, and the appropriate timing of revenue recognition are critical with respect to these arrangements to ensure compliance with GAAP.

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

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Changes to the elements in an arrangement and the amounts allocated to each element could affect the timing and amount of revenue recognition. Revenue recognition also depends on the timing of shipment and is subject to customer acceptance and the readiness of customers facilities. If shipments are not made on scheduled timelines or if the products are not accepted by the customer in a timely manner, our reported revenues may differ materially from expectations.

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

Share-based Compensation Expense

We value our stock options granted and the option component of the shares of VMS common stock purchased under the employee stock purchase plan using the Black-Scholes option-pricing model. We value our performance units using the Monte Carlo simulation model. The determination of fair value of share-based payment awards on the date of grant under both the Black-Scholes option-pricing model and the Monte Carlo simulation model is affected by VMS s stock price, as well as the input of other subjective assumptions, including the expected terms of stock awards and the expected price volatilities of shares of VMS common stocks and peer companies that are used to assess certain performance targets over the expected term of the awards, and the dividend yield of VMS.

The expected term of our stock options is based on the observed and expected time to post-vesting exercise and post-vesting cancellations of stock options by our employees. We determined the expected term of stock options based on the demographic grouping of employees and retirement eligibility. We used a combination of historical and implied volatility, or blended volatility, in deriving the expected volatility assumption for our stock options. Blended volatility represents the weighted average of implied volatility and historical volatility. Implied volatility is derived based on traded options on VMS common stock. Implied volatility is weighted in the calculation of blended volatility based on the ratio of the term of the exchange-traded options to the expected terms of the employee stock options. Historical volatility represents the remainder of the weighting. Our decision to incorporate implied volatility was based on our assessment that implied volatility of publicly traded options on VMS common stock is reflective of market conditions and is generally reflective of both historical volatility and expectations of how future volatility will differ from historical volatility. In determining the extent of use of implied volatility, we considered: (i) the volume of market activity of traded options; (ii) the ability to reasonably match the input variables of traded options to those of stock options granted by us, including the date of grant; (iii) the similarity of the exercise prices; and (iv) the length of term of traded options. After considering the above factors, we determined that we could not rely exclusively on implied volatility based on the fact that the term of VMS exchange-traded options is less than one year and that it is different from the expected terms of the stock options we grant. Therefore, we believe a combination of the historical volatility over the expected terms of the stock options we grant and the implied volatility of exGN=BOTTOM>

Total interest-bearing liabilities

2,034,353

12,162

2.38

%

1,928,569

38,663

2.68

%

1,676,034

43,753

3.49

%

Noninterest bearing deposits	
	422,535
	396,676

350,851

Accrued expenses and other liabilities

39,877

37,866

32,753

Total liabilities

2,496,765

2,363,111

2,059,638

Minority Interest	
	6,060
	3,797

1,477

Shareholders equity

205,301

205,632

187,563

Total liabilities and shareholders equity	
$	**2,708,126**

$

2,572,540

$

2,248,678

Interest rate spread

3.47

%

3.27

%

2.92

%

Net interest income/margin on earning assets

$

24,760

3.92

%

$

67,652

3.79

%

$

56,379

3.61

%

Tax Equivalent Adjustment

(722

)

(2,030

)

(1,824

)

Net interest income per consolidated financial statements	$	**24,038**

$

65,622

$

54,555

(1) Average balances and yields on available-for-sale securities are based on historical amortized cost.

(2) Interest income includes the tax effects of taxable-equivalent adjustments using a combined New York State and Federal effective income tax rate of 40% to increase tax exempt interest income to taxable-equivalent basis.

(3) Nonaccrual loans are included in the average asset totals presented above. Payments received on nonaccrual loans have been recognized as disclosed in Note 1 of the consolidated financial statements.

Provision for Loan and Lease Losses

The provision for loan and lease losses represents management s estimate of the expense necessary to maintain the allowance for loan and lease losses at an adequate level. The provision for loan and lease losses was $1.5 million and $3.3 million for the three and nine months ended September 30, 2008, compared to $387,000 and $1.1 million, for the same periods in 2007. The increase in the provision for the three and nine months ended September 30, 2008 reflects the growth in loans and leases, an increase in net charge-offs and nonperforming loans, and the impacts of a slowing economy. The allowance for loan and lease losses, as a percentage of period end loans was 1.01% at September 30, 2008, compared to 1.04% at September 30, 2007. The section captioned Allowance for Loan and Lease Losses and Nonperforming Assets contained elsewhere in this report has further details on the allowance for loan and lease losses.

Noninterest Income

Noninterest income is a significant source of income for the Company, representing 35.2% of total revenues for the first nine months of 2008, compared to 37.6% for the same period in 2007. Noninterest income for the three months ended September 30, 2008 was $11.4 million, a decrease of 1.2% from the same period in 2007. The economic climate has played a role in this trend as investment services fees, service charges on deposit accounts and card services income were all down slightly from the third quarter of 2007. Year-to-date 2008, noninterest income was $35.7 million, up 8.7% over the same period in 2007. Year-to-date 2008 noninterest income included $1.6 million of pre-tax other income related to proceeds received from the Company s allocation of the Visa, Inc. initial public offering (the Visa IPO), consisting of a $1.2 million gain on the partial redemption of Visa stock and a $0.4 million partial reversal of a fourth quarter 2007 accrual for indemnification charges. Visa withheld a portion of the shares allocated to its member banks to create an escrow account to cover the costs and liabilities associated with certain litigation for which its member banks are obligated to indemnify Visa. Visa s funding of this escrow account allowed member banks to reverse litigation related accruals made in the fourth quarter of 2007, up to each bank s proportionate membership interest of the $3.0 billion used to fund the escrow account.

Investment services income was $3.5 million in the third quarter of 2008, down 3.6% from the same period in 2007. For the first nine months of 2008, investment services income was $10.7 million, an increase of 0.9% over the same period in 2007. Investment services income reflects income from Tompkins Investment Services (TIS), a division within Tompkins Trust Company, and AM&M. Investment services income includes: trust services, financial planning, wealth management services, and brokerage related services. TIS generates fee income through managing trust and investment relationships, managing estates, providing custody services, and managing investments in employee benefits plans. TIS also oversees retail brokerage activities in the Company s banking offices. TIS revenues for the three and nine months ended September 30, 2008, decreased by $232,000 or 12.3%, and $233,000 or 4.3%, respectively, compared to the same periods in 2007. With fees largely based on the market value and the mix of assets managed, the general direction of the stock market has a considerable impact on fee income. TIS has been successful with business development initiatives and customer retention despite the challenging equities market in 2008 and the recent turmoil in the financial markets. The market value of assets managed by, or in custody of, TIS was $1.76 billion at September 30, 2008, down 3.8% from $1.83 billion at September 30, 2007. These figures include $503.4 million and $484.1 million, respectively, of Company-owned securities of which TIS is custodian.

AM&M provides fee-based financial planning services, wealth management services, and brokerage services to independent financial planners and investment advisors. AM&M revenues increased by $79,000 or 4.3% and by $437,000 or 7.9% for the three and nine months ended September 30, 2008, compared to the same periods in 2007. Growth in financial planning and wealth management fees and insurance commissions were partially offset by lower broker-dealer fees, which were unfavorably impacted by weak equities markets. The market value of assets under management by AM&M was $507.3 million at September 30, 2008, down 4.7% from $532.2 million at September 30, 2007.

Insurance commissions and fees for the three and nine months ended September 30, 2008 increased by $138,000 or 4.7%, and $334,000 or 4.0%, respectively, as compared to the same periods in 2007. The growth in insurance commissions and fees was mainly in personal line revenues, and was partly due to an acquisition in the third quarter of 2007.

Service charges on deposit accounts for the three months ended September 30, 2008, decreased by $118,000 or 4.2% as compared to the same period in 2007. For the first nine months of 2008, service charges on deposit accounts increased by $146,000 or 1.9%. The largest component of this category is overdraft fees, which is largely driven by customer activity. Customer activity has been changing over the past several years, with electronic transactions such as debit cards and Internet banking reducing the volume of checks. The Company reviewed and revised the way that it processes these transactions during the second quarter of 2007 to process electronic transactions substantially the same as paper transactions, which has had a favorable impact on overdraft income.

Card services income for the three and nine months ended September 30, 2008, was down $154,000 or 17.4%, and $76,000 or 2.9%, respectively, over the comparable prior year periods. Debit card income is down compared to the prior year mainly due to a new rewards program implemented in the second quarter of 2008, and the associated accrual to reflect the Company s liability under the new rewards program.

Net mark-to-market gains on securities and borrowings held at fair value totaled $1,000 for the three months ended September 30, 2008, compared to net mark-to-market losses on securities and borrowings held at fair value of $298,000 for the three months ended September 30, 2007. Year-to-date 2008, net mark-to-market losses were $334,000, compared to losses of $446,000 for the same period in 2007. Mark-to-market losses or gains relate to the change in the fair value of securities and borrowings where the Company has elected the fair value option.

Noninterest income for the third quarter of 2008 includes $398,000 of income relating to increases in the cash surrender value of corporate owned life insurance (COLI). This compares to $302,000 for the same period in 2007. For the year-to-date period income from this source was up $229,000 or 26.7% over the same period last year. The COLI relates to life insurance policies covering certain executive officers of the Company. The Company s average investment in COLI was $32.2 million for the nine month period ended September 30, 2008, compared to $26.1 million for the same period in 2007. The Company purchased $3.0 million of additional insurance in the fourth quarter of 2007 and acquired $3.5 million in the acquisition of Sleepy Hollow. Although income associated with the insurance policies is not included in interest income, the COLI produced a tax-equivalent return of 7.52% for the first nine months of 2008, compared to 7.33% for the same period in 2007.

Other income for the third quarter of 2008 was $376,000, down $32,000 or 7.8% from the third quarter of 2007. For the nine months ended September 30, 2008, other income was $1.1 million, an increase of $250,000 from the same period prior year. Contributing to the year-to-date increase in other income were the following: increase in earnings related to the Company s investment in a Small Business Investment Company (up $77,000), and gains on sales of fixed assets (up $42,000).

The net gain on sale of available-for-sale securities of $283,000 for the third quarter of 2007 was primarily on the sale of the Company s Mastercard stock that it received as a member bank at the time of Mastercard s initial public offering. The year-to-date 2008 gains of $424,000 reflect sales of available-for-sale securities mainly during the first and second quarters for liquidity purposes and to reinvest proceeds to improve net interest income in light of actions taken by the Federal Reserve that resulted in 200 basis point declines in both the Federal funds rate and prime rate in the first quarter of 2008.

Noninterest Expenses

Total noninterest expenses increased 12.6% to $22.2 million for the three months ended September 30, 2008, compared to $19.7 million for the same period in 2007, and increased 10.0% to $64.3 million for the nine months ended September 30, 2008, from $58.5 million for the same period in 2007. The increase in 2008 over 2007 was primarily in salary and wages and occupancy related expenses, which were all impacted by the Sleepy Hollow acquisition. Changes in the components of noninterest expense are discussed below.

Personnel-related expense, which includes salary, wages, pension and other employee benefits, increased by $1.1 million or 9.7%, and $2.8 million or 8.1%, respectively, for the three and nine-month periods ended September 30, 2008 compared to the same periods in 2007. Salaries and wages for the three months and nine months ended September 30, 2008 were up $1.2 million or 12.9% and $2.7 million or 10.3%, respectively, compared to the same period in 2007. The increases in both periods were primarily related to the staffing requirement for six banking offices added in May 2008, with the acquisition of Sleepy Hollow. Actual full time equivalent employees (FTEs) totaled 698 at September 30, 2008 compared to 644 at September 30, 2007. Pension and other employee benefits for the three months and nine months ended September 30, 2008 were down $37,000 or 1.4%, and up $41,000 or 0.5%, respectively, compared to the same period in 2007. Increases in healthcare and other post-retirement benefits were mainly offset by lower pension related expenses. The third quarter and year-to-date 2007 results included pre-tax severance charges of $740,000 related to reorganization and profit improvement initiatives implemented in 2007.

Expenses related to bank premises and furniture and fixtures increased by $360,000 or 14.8% and by $812,000 or 10.9% for the three and nine month periods ended September 30, 2008 compared to the same periods in 2007. Additions to the company s branch network as well as increases in depreciation, real estate taxes and utilities contributed to the increased expenses for premises and furniture and fixtures year-over-year. The acquisition of Sleepy Hollow in May of 2008 added six banking offices to the Company s branch network.

Marketing expense for the three and nine months ended September 30, 2008, were up by $87,000 or 15.3%, and $345,000 or 19.7%, respectively, compared to the same periods in 2007. The primary reason for the period over period increase was the residual expenses for ad campaigns and mailings related to the addition of six new branches in the acquisition of Sleepy Hollow.

Professional fees for the three and nine months ended September 30, 2008, were down by $346,000 or 33.1%, and $539,000 or 20.7%, respectively, compared to the same periods in 2007. The third quarter and year-to-date periods in 2007 included consulting fees of $447,000 and $827,000, respectively, related to the implementation of certain profit improvement initiatives in 2007.

Software licensing and maintenance expense for the three and nine months ended September 30, 2008 increased by $103,000 or 18.7%, and $489,000 or 31.4% over the same periods in 2007. Contributing to the increase in 2008 was an increase in core operating system expense, and process improvement related initiatives.

Cardholder expense of $407,000 increased by $166,000 for three months ended September 30, 2008, compared to $241,000 for the same period in 2007, and increased $188,000 or 25.7% for the nine months ended September 30, 2008. The increases are primarily due to some one-time expenses related to the conversion to a new card processing system in the second quarter of 2008.

Other operating expenses increased by $911,000 or 29.8%, and $1.7 million or 17.6% for the three and nine month periods ended September 30, 2008, compared to the same periods in 2007. Contributing to the year-to-date increase in other operating expenses were the following: telephone (up $92,000), printing and supplies (up $205,000); regulatory agency expense (up $394,000), and merger related expenses (up $73,000). The increase in regulatory expense resulted as available FDIC assessment credits awarded for prior contributions were mostly utilized for assessments through June 30, 2008, and an increase in total deposits. In October 2008, the FDIC announced its intention to increase deposit insurance assessments beginning in 2009 to ensure that the FDIC deposit insurance fund can adequately cover projected losses from future bank failures. The projected increase would effectively double the average insurance premiums paid by banks and thrifts.

Income Tax Expense

The provision for income taxes provides for Federal and New York State income taxes. The provision for the three months ended September 30, 2008, was $3.7 million, compared to $3.2 million for the same period in 2007. For the year-to-date period ended September 30, 2008, the provision was $10.8 million compared to $8.8 million for the same period in 2007. The Company s effective tax rate for the third quarters of 2008 and 2007 was 31.6%. For the nine months ended September 30, 2008, the effective tax rate was 32.2%, compared to 31.7% for the comparable prior year period. The increase in the effective tax rate for the first nine months of 2008 compared to 2007 was primarily the result of nontaxable items representing a smaller percentage of the higher pre-tax income for the nine months ended September 30, 2008 as compared to the prior year period.

FINANCIAL CONDITION

Total assets were $2.7 billion at September 30, 2008, up $365.6 million or 15.5% over December 31, 2007, and up 17.6% over September 30, 2007. Asset growth includes $269.1 million of assets acquired in the acquisition of Sleepy Hollow. Asset growth over year-end 2007 included a $51.5 million increase in securities ($46.9 million acquired from Sleepy Hollow), a $278.3 million increase in the total loans and leases ($151.2 million acquired from Sleepy Hollow), and a $5.8 million increase in cash and equivalents.

Loans totaled $1.7 billion or 63.1% of total assets at September 30, 2008, compared to $1.4 billion or 61.0% of total assets at December 31, 2007. The 19.3% growth in total loans from year-end 2007 was mainly in commercial real estate, residential real estate, and commercial loans and included $151.2 million of loans purchased in the acquisition of Sleepy Hollow. Residential real estate loans, including home equity loans, were up $108.1 million or 21.3%, and commercial real estate and commercial loans were up $159.2 million or 18.9%. Consumer loans were up $6.1 million or 7.5% over December 31, 2007.

Nonperforming loans (loans on nonaccrual, loans past due 90 days or more and still accruing interest, and loans restructured where the terms of repayment have been renegotiated, resulting in a reduction and or deferral of interest and principal) were $12.6 million at September 30, 2008, up from $9.3 million at December 31, 2007. Nonperforming loans represented 0.73% of total loans at September 30, 2008, compared to 0.65% of total loans at December 31, 2007. The increase in nonperforming loans was mainly a result of nonperforming loans acquired in the Sleepy Hollow acquisition. For the nine months ended September 30, 2008, net charge-offs were $2.1 million, up from $968,000 in the same period of 2007.

Over the past year or so, there has been significant attention to subprime consumer real estate lending in the media. The Company has not engaged in the origination or purchase of subprime loans as a line of business and residential loan charge-offs amounted to $98,000 for the nine months ended September 30, 2008, compared to $98,000 for the same period in 2007. In addition, the combined nonperforming loan balances in our construction and home equity lending portfolios represents less than 0.05% of total loans.

As of September 30, 2008, total securities were $800.4 million or 29.4% of total assets, compared to $748.9 million or 31.7% of total assets at year-end 2007. The portfolio is comprised primarily of mortgage-backed securities, obligations U.S. of Government sponsored agencies, and obligations of states and political subdivisions. The Company has no investments in preferred stock of U.S. Government sponsored agencies, no investments in pools of Trust Preferred securities, and no securities where management has deemed impairment to be other than temporary. The after-tax unrealized gain on the available-for-sale securities was $41,348 at September 30, 2008, compared to an after-tax unrealized gain of $1.3 million at December 31, 2007.

As of September 30, 2008, the trading portfolio totaled $38.8 million, down from $60.1 million at December 31, 2007. The decrease reflects maturities during the first nine months of 2008.

Total deposits were $2.1 billion at September 30, 2008, up $373.8 million or 21.7% over December 31, 2007, and up $368.9 million or 21.4% over September 30, 2007. The Company acquired $229.0 million of deposits in the acquisition of Sleepy Hollow. The growth in total deposits from December 31, 2007 was mainly in money market and savings balances, which were up $232.7 million or 31.4% ($93.1 million acquired in Sleepy Hollow acquisition). Noninterest bearing deposit balances were up $25.7 million or 6.5% ($24.5 million acquired in Sleepy Hollow acquisition). Time deposit balances were up $115.4 million or 19.7% ($109.2 million acquired in Sleepy Hollow acquisition). Other borrowings decreased $25.8 million from year-end 2007 to $185.1 million at September 30, 2008, as the Company paid down some overnight FHLB borrowings with the increase in deposit balances. During the second quarter of 2007, the Company elected the fair value option for $25.0 million of FHLB borrowings incurred during the quarter. Since December 31, 2007, the fair value of these borrowings increased by $162,000.

Capital

Total shareholders equity totaled $212.6 million at September 30, 2008, an increase of $15.4 million from December 31, 2007. Additional paid-in capital increased by $4.1 million, from $147.7 million at December 31, 2007, to $151.8 million at September 30, 2008, reflecting $3.1 million in proceeds from stock option exercises and $683,000 related to stock-based compensation. Retained earnings increased $12.5 million from $57.3 million at December 31, 2007, to $69.8 million at September 30, 2008, reflecting net income of $22.6 million less dividends paid of $9.4 million and a cumulative-effect adjustment of $582,000 related to the adoption of EITF 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements.* Accumulated other comprehensive loss increased by $989,000 from a net unrealized loss of $6.9 million at December 31, 2007, to a net unrealized loss of $7.9 million at September 30, 2008, reflecting a decrease in unrealized gains on available-for-sale securities due to higher market rates, partially offset by amounts recognized in other comprehensive income related to postretirement benefit plans. Under regulatory requirements, amounts reported as accumulated other comprehensive income/loss related to net unrealized gain or loss on available for sale securities and the funded status of the Corporation s defined benefit post-retirement benefit plans do not increase or reduce regulatory capital and are not included in the calculation of risk-based capital and leverage ratios.

Cash dividends paid in the first nine months of 2008 totaled approximately $9.4 million, representing 41.8% of year-to-date earnings. Cash dividends of $0.98 per share paid during the first nine months of 2008 were up 6.5% over cash dividends of $0.92 per share paid in the first nine months of 2007.

On July 22, 2008, the Company s Board of Directors approved a stock repurchase plan (the 2008 Plan). The 2008 Plan authorizes the repurchase of up to 150,000 shares of the Company s outstanding common stock over a two-year period. The 2008 Plan replaces a previous repurchase plan that expired in July 2008. The Company did not repurchase any shares of common stock under the previous plan during the first nine months of 2008. Over the life of the plan approved in 2006, the Company repurchased 420,575 shares.

The Company and its banking subsidiaries are subject to various regulatory capital requirements administered by Federal banking agencies. Management believes the Company and its subsidiaries meet all capital adequacy requirements to which they are subject. The table below reflects the Company s capital position at September 30, 2008, compared to the regulatory capital requirements for well capitalized institutions.

REGULATORY CAPITAL ANALYSIS September 30, 2008

(Dollar amounts in thousands)	Actual Amount	Actual Ratio	Well Capitalized Requirement Amount	Well Capitalized Requirement Ratio
Total Capital (to risk weighted assets)	$ 202,872	10.9%	$ 185,463	10.0%
Tier I Capital (to risk weighted assets)	$ 185,410	10.0%	$ 111,278	6.0%
Tier I Capital (to average assets)	$ 185,410	7.0%	$ 133,335	5.0%

As illustrated above, the Company s capital ratios on September 30, 2008, remain well above the minimum requirements for well capitalized institutions. As of September 30, 2008, the capital ratios for each of the Company s subsidiary banks also exceeded the minimum levels required to be considered well capitalized. The Company and its affiliates remained well capitalized after the May 9, 2008 acquisition of Sleepy Hollow Bancorp.

Allowance for Loan and Lease Losses and Nonperforming Assets

Management reviews the adequacy of the allowance for loan and lease losses (the allowance) on a regular basis. Management considers the accounting policy relating to the allowance to be a critical accounting policy, given the inherent uncertainty in evaluating the levels of the allowance required to cover credit losses in the Company s portfolio and the material effect that assumption could have on the Company s results of operations. Factors considered in determining the adequacy of the allowance and the related provision include: management s approach to granting new credit; the ongoing monitoring of existing credits by the internal and external loan review functions; the growth and composition of the loan and lease portfolio; the level and trend of market interest rates; comments received during the course of regulatory examinations; current local economic conditions; past due and nonperforming loan statistics; estimated collateral values; and an historical review of loan and lease loss experience.

The allowance represented 1.01% of total loans and leases outstanding at September 30, 2008, compared to 1.01% at December 31, 2007 and 1.04% at September 30, 2007. The allowance coverage of nonperforming loans (loans past due 90 days and accruing, nonaccrual loans, and restructured troubled debt) was 1.4 times at September 30, 2008, 1.6 times at December 31, 2007, and 1.7 times at September 30, 2007. Based upon consideration of the above factors, management believes that the allowance is adequate to provide for the risk of loss inherent in the current loan and lease portfolio. Activity in the Company s allowance for loan and lease losses during the first nine months of 2008 and 2007 and for the 12 months ended December 31, 2007 is illustrated in the table below.

ANALYSIS OF THE ALLOWANCE FOR LOAN AND LEASE LOSSES (In thousands)

	09/30/08	12/31/07	09/30/07
Average loans and leases outstanding during the period	$ 1,564,185	$ 1,362,417	$ 1,348,397
Total loans and leases outstanding at end of period	$ 1,718,378	$ 1,440,122	$ 1,383,928
ALLOWANCE FOR LOAN AND LEASE LOSSES			
Beginning balance	$ 14,607	$ 14,328	$ 14,328
Provision for loan and lease losses	3,323	1,529	1,050
Loans charged off	(2,452)	(1,760)	(1,356)
Loan recoveries	343	510	388
Net charge-offs	(2,109)	(1,250)	(968)
Allowance acquired in purchase acquisition	1,485	0	0

Ending balance	$ 17,306	$ 14,607	$ 14,410
Allowance for loan and lease losses to total loans and leases	1.01%	1.01%	1.04%
Annualized net charge-offs to average loans and leases	0.18%	0.09%	0.10%

Net charge-offs for the nine months ended September 30, 2008 totaled $2.1 million compared to $968,000 in the comparable year ago period. Contributing to the increase in net charge-offs in 2008 over 2007 was a $400,000 charge-off taken on one commercial credit in the third quarter of 2008. Annualized net charge-offs for the first nine months of the year represented 0.18% of average loans, up from 0.10% for the first nine months of 2007. The provision for loan and lease losses totaled $3.3 million for the nine months ended September 30, 2008 compared to $1.1 million for the same period in 2007. Higher net charge-offs and nonperforming loans, growth in the loan portfolio, and concern over economic conditions contributed to the increase in the provision for loan and leases losses in 2008 over 2007.

The level of nonperforming assets at September 30, 2008, and 2007, and December 31, 2007 is illustrated in the table below. Nonperforming assets of $13.1 million as of September 30, 2008, were up $3.7 million from nonperforming assets of $9.4 million at year-end 2007. Nonperforming assets represented 0.48% of total assets at September 30, 2008, compared to 0.40% at December 31, 2007, and 0.37% at September 30, 2007. The increase in nonperforming assets was partially due to the second quarter of 2008 acquisition of Sleepy Hollow, which added about $2.6 million of nonperforming assets. Approximately $3.5 million of nonperforming loans at September 30, 2008, were secured by U.S. government guarantees, while $1.5 million were secured by one-to-four family residential properties.

As of September 30, 2008, the Company s recorded investment in loans and leases that are considered impaired totaled $8.4 million compared to $7.0 million at September 30, 2007. The $8.4 million of impaired loans at September 30, 2008, had related allowances of $224,000, and the $7.0 million of impaired loans at September 30, 2007, had related allowances of $66,000.

NONPERFORMING ASSETS (In thousands)

	09/30/08	12/31/07	09/30/07
Nonaccrual loans and leases	$ 12,463	$ 8,890	$ 7,869
Loans past due 90 days and accruing	0	312	370
Troubled debt restructuring not included above	132	145	0
Total nonperforming loans	12,595	9,347	8,239
Other real estate, net of allowances	526	5	345
Total nonperforming assets	$ 13,121	$ 9,352	$ 8,584
Total nonperforming loans and leases as a percentage of total loans and leases	0.73%	0.65%	0.60%
Total nonperforming assets as a percentage of total assets	0.48%	0.40%	0.37%

Potential problem loans and leases are loans and leases that are currently performing, but where known information about possible credit problems of the related borrowers causes management to have doubt as to the ability of such borrowers to comply with the present loan payment terms and may result in disclosure of such loans and leases as nonperforming at some time in the future. Management considers loans and leases classified as Substandard that continue to accrue interest to be potential problem loans and leases. At September 30, 2008, the Company s internal loan review function had identified 36 commercial relationships totaling $10.8 million, which it has classified as Substandard, which continue to accrue interest. As of December 31, 2007, the Company s internal loan review function had classified 34 commercial relationships as Substandard totaling $13.4 million, which continued to accrue interest. These loans remain in a performing status due to a variety of factors, including payment history, the value of collateral supporting the credits, and personal or government guarantees. These factors, when considered in the aggregate, give management reason to believe that the current risk exposure on these loans is not significant. However, these loans do exhibit certain risk factors, which have the potential to cause them to become nonperforming. Accordingly, management s attention is focused on these credits, which are reviewed at least quarterly.

Deposits and Other Liabilities

Total deposits of $2.1 billion at September 30, 2008, were up $373.8 million or 21.7% from December 31, 2007. Deposit growth included $232.7 million in savings and money market balances, $115.4 million in time deposits and $25.7 million in noninterest bearing deposits. A large portion of the growth was due to the Sleepy Hollow acquisition. Total deposits in Sleepy Hollow Bank s five Westchester County, New York branches were $229.0 million at the time of the acquisition. Growth in municipal deposits accounted for a majority of the increase in savings and money market balances from year-end 2007. In 2007 and 2008, the Federal Reserve reduced short-term market rates, which led to a decrease in rates paid on deposits. With deposit rates down on time deposits and more in line with money market rates, municipalities are placing tax deposits into money market accounts. Municipal deposit balances are somewhat seasonal, increasing as tax deposits are collected and decreasing as these monies are used by the municipality.

The Company s primary funding source is core deposits, defined as total deposits less time deposits of $100,000 or more, brokered time deposits, and municipal money market deposits. Core deposits increased 20.3% from year-end 2007 to $1.6 billion at September 30, 2008 and represented 64.9% of total liabilities. The addition of five banking offices acquired in the Sleepy Hollow acquisition contributed to the growth in core deposits.

The Company also uses non-core funding sources, which include municipal money market deposits, time deposits of $100,000 or more, brokered deposits, term advances and securities sold under agreements to repurchase (repurchase agreements) with the Federal Home Loan Bank (FHLB), and retail repurchase agreements, to support asset growth. Non-core funding totaled $844.6 million at September 30, 2008, up from $775.7 million at December 31, 2007. The increase in non-core funding between December 31, 2007, and September 30, 2008, was concentrated in municipal money market deposits, which were up $46.3 million to $166.1 million at September 30, 2008 and time deposits of $100,000 or more which were up $46.8 million.

The Company s liability for repurchase agreements amounted to $190.3 million at September 30, 2008, which is down from $195.4 million at December 31, 2007. Included in repurchase agreements at September 30, 2008, were $152.4 million in FHLB repurchase agreements and $37.9 million in retail repurchase agreements. Retail repurchase agreements are arrangements with local customers of the Company, in which the Company agrees to sell securities to the customer with an agreement to repurchase those securities at a specified later date. Included in the $152.4 million of repurchase agreements with the FHLB are $137.4 million that have call dates between 2007 and 2017 and are callable if certain conditions are met. Also included in the $152.4 million are $15.0 million of repurchase agreements with the FHLB where the Company has elected to adopt the fair value option under SFAS 159. The fair value of these repurchase agreements has increased by $41,000 (net mark-to-market pre-tax loss of $41,000) since December 31, 2007.

At September 30, 2008, other borrowings of $185.1 million included $155.9 million of term advances with the FHLB, and a $21.0 million term borrowing with a money center bank. Included in the $155.9 million of term advances with the FHLB are $144.0 million of advances that have call dates between 2007 and 2017 and are callable if certain conditions are met. The Company elected the fair value option under SFAS 159 for a $10.0 million advance with the FHLB. The fair value of this advance has increased by $121,000 (net mark-to-market pre-tax loss of $121,000) from year-end 2007.

Liquidity

The objective of liquidity management is to ensure the availability of adequate funding sources to satisfy the demand for credit, deposit withdrawals, and business investment opportunities. The Company s large, stable core deposit base and strong capital position are the foundation for the Company s liquidity position. The Company uses a variety of resources to meet its liquidity needs, which include deposits, cash and cash equivalents, short-term investments, cash flow from lending and investing activities, repurchase agreements, and borrowings. Asset and liability positions are monitored primarily through Asset/Liability Management Committees of the Company s subsidiary banks individually and on a combined basis. These Committees review periodic reports on liquidity and interest rate sensitivity positions. Comparisons with industry and peer groups are also monitored. The Company s strong reputation in the communities it serves, along with its strong financial condition, provides access to numerous sources of liquidity as described below. Management believes these diverse liquidity sources provide sufficient means to meet all demands on the Company s liquidity that are reasonably likely to occur.

Core deposits are a primary and low cost funding source obtained primarily through the Company s branch network. Core deposits totaled $1.6 billion at September 30, 2008, up $274.0 million or 20.3% from year-end 2007, and $255.2 million or 18.6% from September 30, 2007. Core deposits represented 77.6% of total deposits and 64.9% of total liabilities at September 30, 2008, compared to 78.5% of total deposits and 62.5% of total liabilities at December 31, 2007.

In addition to core deposits, the Company uses non-core funding sources to support asset growth. These non-core funding sources include time deposits of $100,000 or more, brokered time deposits, municipal money market deposits, securities sold under agreements to repurchase and term advances from the FHLB. Rates and terms are the primary determinants of the mix of these funding sources. Non-core funding sources, as a percentage of total liabilities, were 33.7% at September 30, 2008, down from 35.9% at December 31, 2007.

Cash and cash equivalents totaled $55.6 million as of September 30, 2008, up from $49.9 million at December 31, 2007. Short-term investments, consisting of securities due in one year or less, decreased from $68.0 million at December 31, 2007, to $43.1 million on September 30, 2008. The Company also has $38.8 million of securities designated as trading securities. The Company pledges securities as collateral for certain non-core funding sources. Securities carried at $577.5 million at December 31, 2007, and $664.2 million at September 30, 2008, were pledged as collateral for public deposits or other borrowings, and pledged or sold under agreements to repurchase. Pledged securities represented 83.0% of total securities as of September 30, 2008, compared to 77.1% as of December 31, 2007.

Cash flow from the loan and investment portfolios provides a significant source of liquidity. These assets may have stated maturities in excess of one year, but have monthly principal reductions. Total mortgage-backed securities, at fair value, were $427.4 million at September 30, 2008, compared with $382.2 million at December 31, 2007. Outstanding principle balances of residential mortgage loans, consumer loans, and leases totaled approximately $716.5 million at September 30, 2008 as compared to $597.4 million at December 31, 2007. Aggregate amortization from monthly payments on these assets provides significant additional cash flow to the Company.

Liquidity is enhanced by ready access to national and regional wholesale funding sources including Federal funds purchased, repurchase agreements, brokered certificates of deposit, and FHLB advances. Through its subsidiary banks, the Company has borrowing relationships with the FHLB and correspondent banks, which provide secured and unsecured borrowing capacity. At September 30, 2008, the unused borrowing capacity on established lines with the FHLB was $443.5 million. As members of the FHLB, the Company s subsidiary banks can use certain unencumbered mortgage-related assets to secure additional borrowings from the FHLB. At September 30, 2008, total unencumbered residential mortgage loans of the Company were $200.3 million. Additional assets may also qualify as collateral for FHLB advances upon approval of the FHLB.

The Company has not identified any trends or circumstances that are reasonably likely to result in material increases or decreases in liquidity in the near term.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

Interest rate risk is the primary market risk category associated with the Company s operations. Interest rate risk refers to the volatility of earnings caused by changes in interest rates. The Company manages interest rate risk using income simulation to measure interest rate risk inherent in its on-balance sheet and off-balance sheet financial instruments at a given point in time. The simulation models are used to estimate the potential effect of interest rate shifts on net interest income for future periods. Each quarter, the Asset/Liability Management Committee reviews the simulation results to determine whether the exposure of net interest income to changes in interest rates remains within board-approved levels. The Committee also considers strategies to manage this exposure and incorporates these strategies into the investment and funding decisions of the Company. The Company does not currently use derivatives, such as interest rate swaps, to manage its interest rate risk exposure, but may consider such instruments in the future.

In our most recent simulation, the base case scenario, which assumes interest rates remain unchanged from the date of the simulation, showed an increase in the net interest margin over the next six months as funding costs benefit from the recent reduction in interest rates, followed by a relatively flat net interest margin for the next six months.

The Company s Board of Directors has set a policy that interest rate risk exposure will remain within a range whereby net interest income will not decline by more than 10% in one year as a result of a 200 basis point parallel change in rate. Given the current level of interest rates, the Company used 100 basis points in the down interest rate scenario in the current model. Based upon the simulation analysis performed as of September 30, 2008, a 200 basis point parallel upward shift in interest rates over a one-year time frame would result in a one-year decline from the base case in net interest income of approximately 2.3%, while a 100 basis point parallel decline in interest rates over a one-year period would result in a decrease from the base case in net interest income of 0.2%. This simulation assumes no balance sheet growth and no management action to address balance sheet mismatches. As of September 30, 2007, the model simulations projected that a 200 basis point parallel upward shift in interest rates over a one-year time frame would result in a one-year decline from the base case in net interest income of approximately 1.4%, while a 200 basis point parallel decline in interest rates over a one-year period would result in a decrease from the base case in net interest income of 3.5%.

The negative exposure in the 200 basis point parallel rising rate environment is mainly driven by the repricing assumptions of the Company s core deposit base and the lag in the repricing of the Company s adjustable rate assets. Longer-term, the impact of a rising rate environment is positive as the asset base continues to reset at higher levels, while the repricing of the rate sensitive liabilities moderates. The negative exposure in the 100 basis point parallel declining interest rate scenario results from the Company s assets repricing downward more rapidly than the rates on the Company s interest-bearing liabilities, mainly deposits. Rates on savings and money market accounts are at low levels given the recent Federal Reserve cuts in short-term market rates. In addition, the model assumes that prepayments accelerate in the down interest rate environment resulting in additional pressure on asset yields and cash flows are reinvested at lower rates.

Although the simulation model is useful in identifying potential exposure to interest rate movements, actual results may differ from those modeled as the repricing, maturity, and prepayment characteristics of financial instruments may change to a different degree than modeled. In addition, the model does not reflect actions that management may employ to manage its interest rate risk exposure. The Company s current liquidity profile, capital position, and growth prospects offer management a level of flexibility to take actions that could offset some of the negative effects of unfavorable movements in interest rates. Management believes the current exposure to changes in interest rates is not significant in relation to the earnings and capital strength of the Company.

In addition to the simulation analysis, management uses an interest rate gap measure. The table below is a Condensed Static Gap Report, which illustrates the anticipated repricing intervals of assets and liabilities as of September 30, 2008. The Company s one-year interest rate gap was a negative $189,000 or 6.9% of total assets at September 30, 2008, compared to a negative $149,000 or 6.4% of total assets at December 31, 2007. A negative gap position exists when the amount of interest-bearing liabilities maturing or repricing exceeds the amount of interest-earning assets maturing or repricing within a particular time period. This analysis suggests that the Company s net interest income is more vulnerable to a rising rate environment than it is to sustained low interest rates. An interest rate gap measure could be significantly affected by external factors such as a rise or decline in interest rates, loan or securities prepayments, and deposit withdrawals.

Condensed Static Gap September 30, 2008		**Repricing Interval**			
(Dollar amounts in thousands)	**Total**	**0-3 months**	**3-6 months**	**6-12 months**	**Cumulative 12 months**
Interest-earning assets	**$ 2,484,746**	**$ 577,093**	**$ 160,026**	**$ 260,898**	**$ 998,017**
Interest-bearing liabilities	**2,050,431**	**827,956**	**182,010**	**176,814**	**$ 1,186,780**
Net gap position		**(250,863)**	**(21,984)**	**84,084**	**(188,763)**
Net gap position as a percentage of total assets		**(9.21%)**	**(0.81%)**	**3.09%**	**(6.93%)**

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company s management, including its Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operations of the Company s disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of September 30, 2008. Based upon that evaluation, the Company s Chief Executive Officer and Chief Financial Officer concluded that as of the end of the period covered by this Report on Form 10-Q the Company s disclosure controls and procedures were effective in providing reasonable assurance that any information required to be disclosed by the Company in its reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms and that material information relating to the Company and its subsidiaries is made known to management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding disclosure.

Changes in Internal Control Over Financial Reporting

There were no changes in the Company s internal control over financial reporting that occurred during the Company s third quarter ended September 30, 2008, that materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

None

Item 1A. Risk Factors

Material changes to Risk Factors as previously disclosed in Form 10-K: Refer to the discussion on page 18 in this Report under Recent Market Developments relating to material changes to the risk factors as presented in the Company s Annual Report on Form 10-K (for the year ended December 31, 2007) and the Company s most recent prior Quarterly Report on Form 10-Q (for the quarter ended June 30, 2008). In response to recent events in the financial markets, congress may enact legislation and regulators may promulgate regulations that have an impact on financial institutions, such as protecting certain classes of borrowers from foreclosure actions.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds
Issuer Purchases of Equity Securities

The following table includes all Company repurchases made on a monthly basis during the period covered by this Quarterly Report on Form 10-Q, including those made pursuant to publicly announced plans or programs.

Period	Total Number of Shares Purchased (a)	Average Price Paid Per Share (b)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (c)	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (d)
July 1, 2008 through July 31, 2008	1,597	$ 46.81	0	150,000
August 1, 2008 through August 31, 2008	0	0	0	150,000
September 1, 2008 through September 30, 2008	0	0	0	150,000
Total	1,597	$ 46.81	0	150,000

On July 22, 2008, the Company s Board of Directors approved a stock repurchase plan (the 2008 Plan). The 2008 Plan authorizes the repurchase of up to 150,000 shares of the Company s outstanding common stock over a two-year period. The 2008 Plan replaces a previous repurchase plan that expired in July 2008.

Included above are 1,597 shares purchased in July 2008, at an average cost of $46.81, by the trustee of the rabbi trust established by the Company under the Company s Stock Retainer Plan For Eligible Directors of Tompkins Financial Corporation and Participating Subsidiaries, and were part of the director deferred compensation under that plan. Shares purchased under the rabbi trust are not part of the Board approved stock repurchase plan.

Recent Sales of Unregistered Securities

None.

Item 3. Defaults Upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 5. Other Information

None

Item 6. **Exhibits**

31.1	Certification of Principal Executive Officer and required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended (filed herewith).
31.2	Certification of Principal Financial Officer and required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended (filed herewith).
32.1	Certification of Principal Executive Officer and required by Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, 18 U.S.C. Section 1350 (filed herewith)
32.2	Certification of Principal Financial Officer and required by Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, 18 U.S.C. Section 1350 (filed herewith)

SIGNATURES

Pursuant to the requirements of the Securities Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: November 6, 2008

TOMPKINS FINANCIAL CORPORATION

By: /s/ Stephen S. Romaine

Stephen S. Romaine
President and
Chief Executive Officer
(Principal Executive Officer)

By: /s/ Francis M. Fetsko

Francis M. Fetsko
Executive Vice President and
Chief Financial Officer
(Principal Financial Officer)

EXHIBIT INDEX

Exhibit Number	Description	Pages
31.1	Certification of Principal Executive Officer and required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.	34
31.2	Certification of Principal Financial Officer and required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.	35
32.1	Certification of Principal Executive Officer and required by Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, 18 U.S.C. Section 1350	36
32.2	Certification of Principal Financial Officer and required by Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, 18 U.S.C. Section 1350	37