MASIMO CORP
Form 10-Q
August 02, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended July 1, 2017

OR

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

For the transition period from _________ to _________

Commission File Number 001-33642

MASIMO CORPORATION
(Exact Name of Registrant as Specified in its Charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	33-0368882 (I.R.S. Employer Identification Number)
52 Discovery Irvine, California	92618
(Address of Principal Executive Offices)	(Zip Code)

(949) 297-7000
(Registrant’s Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the

Exchange Act. ¨
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No ý
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

Class	Number of Shares Outstanding as of July 1, 2017
Common stock, $0.001 par value	51,940,147

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

	July 1, 2017	December 31, 2016
ASSETS		
Current assets		
Cash and cash equivalents	$331,448	$ 305,970
Accounts receivable, net of allowance for doubtful accounts of $1,460 and $1,698 at July 1, 2017 and December 31, 2016, respectively.	104,159	101,667
Inventories	88,458	72,542
Other current assets	41,929	27,048
Total current assets	565,994	507,227
Deferred cost of goods sold	93,936	79,948
Property and equipment, net	137,723	135,996
Intangible assets, net	28,099	29,376
Goodwill	20,388	19,780
Deferred tax assets	39,012	38,975
Other non-current assets	10,516	9,223
Total assets	$895,668	$ 820,525
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$38,270	$ 34,334
Accrued compensation	31,871	43,180
Accrued and other current liabilities	36,677	104,654
Deferred revenue	38,526	38,198
Total current liabilities	145,344	220,366
Deferred revenue	24,652	25,336
Other non-current liabilities	16,268	14,587
Total liabilities	186,264	260,289
Commitments and contingencies		
Stockholders' equity		
Preferred stock, $0.001 par value; 5,000 shares authorized; 0 shares issued and outstanding at July 1, 2017 and December 31, 2016	—	—
Common stock, $0.001 par value; 100,000 shares authorized; 51,940 and 50,188 shares issued and outstanding at July 1, 2017 and December 31, 2016, respectively	52	50
Treasury stock, 14,255 shares at July 1, 2017 and December 31, 2016	(404,276)	(404,276)
Additional paid-in capital	436,549	382,263
Accumulated other comprehensive loss	(4,161)	(7,027)
Retained earnings	681,240	589,226
Total stockholders' equity	709,404	560,236
Total liabilities and stockholders' equity	$895,668	$ 820,525

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

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MASIMO CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited, in thousands, except per share amounts)

	Three Months Ended		Six Months Ended	
	July 1, 2017	July 2, 2016	July 1, 2017	July 2, 2016
Revenue:				
Product	$182,802	$164,607	$360,899	$327,897
Royalty and other revenue	10,131	8,029	18,336	15,906
Total revenue	192,933	172,636	379,235	343,803
Cost of goods sold	64,496	57,501	126,664	114,455
Gross profit	128,437	115,135	252,571	229,348
Operating expenses:				
Selling, general and administrative	66,377	63,888	131,949	126,399
Research and development	15,192	14,818	30,559	29,183
Total operating expenses	81,569	78,706	162,508	155,582
Operating income	46,868	36,429	90,063	73,766
Non-operating income	158	471	1,032	969
Income before provision for income taxes	47,026	36,900	91,095	74,735
Provision (benefit) for income taxes	346	6,877	(919)	17,135
Net income	$46,680	$30,023	$92,014	$57,600
Net income per share:				
Basic	$0.90	$0.61	$1.80	$1.17
Diluted	$0.83	$0.57	$1.65	$1.10
Weighted-average shares used in per share calculations:				
Basic	51,677	49,256	51,164	49,340
Diluted	56,173	52,703	55,867	52,404

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

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MASIMO CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(unaudited, in thousands)

	Three Months Ended		Six Months Ended	
	July 1, 2017	July 2, 2016	July 1, 2017	July 2, 2016
Net income	$46,680	$30,023	$92,014	$57,600
Other comprehensive income, net of tax:				
Foreign currency translation adjustments	2,300	(1,209)	2,866	190
Comprehensive income	$48,980	$28,814	$94,880	$57,790

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

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MASIMO CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited, in thousands)

	Six Months Ended	
	July 1, 2017	July 2, 2016
Cash flows from operating activities:		
Net income	$92,014	$57,600
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	9,462	8,132
Stock-based compensation	6,142	6,204
Loss on disposal of property, equipment and intangibles	365	401
Gain on deconsolidation of variable interest entity	—	(273)
Provision for doubtful accounts	(193)	(51)
Provision for deferred income taxes	—	5,001
Changes in operating assets and liabilities:		
Increase in accounts receivable	(2,094)	(3,739)
Increase in inventories	(15,554)	(297)
Increase in other current assets	(14,694)	(7,462)
Increase in deferred cost of goods sold	(13,700)	(1,566)
Increase in other non-current assets	(1,288)	(6,596)
Increase in accounts payable	3,139	7,943
Decrease in accrued compensation	(11,679)	(3,937)
Decrease in accrued liabilities	(67,641)	(13,807)
Increase in deferred revenue	327	5,263
Increase in other non-current liabilities	985	3,875
Net cash (used in) provided by operating activities	(14,409)	56,691
Cash flows from investing activities:		
Purchases of property and equipment, net	(8,512)	(10,734)
Increase in intangible assets	(1,574)	(1,349)
Reduction in cash resulting from deconsolidation of variable interest entity	—	(763)
Net cash used in investing activities	(10,086)	(12,846)
Cash flows from financing activities:		
Borrowings under line of credit	—	45,000
Repayments on line of credit	—	(55,000)
Debt issuance costs	—	(621)
Repayments of capital lease obligations	(70)	(69)
Proceeds from issuance of common stock	48,218	18,997
Repurchases of common stock	—	(68,218)
Net cash provided by (used in) financing activities	48,148	(59,911)
Effect of foreign currency exchange rates on cash	1,825	(196)
Net increase in cash and cash equivalents	25,478	(16,262)
Cash and cash equivalents at beginning of period	305,970	132,317
Cash and cash equivalents at end of period	$331,448	$116,055

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

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MASIMO CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. Description of the Company

Masimo Corporation (the Company) is a global medical technology company that develops, manufactures and markets a variety of noninvasive patient monitoring technologies. The Company's mission is to improve patient outcomes and reduce cost of care by taking noninvasive monitoring to new sites and applications®. The Company's patient monitoring solutions generally incorporate a monitor or circuit board, proprietary single-patient use or reusable sensors, software and/or cables. The Company primarily sells its products to hospitals, emergency medical service providers, home care providers, physician offices, veterinarians, long term care facilities and consumers through its direct sales force, distributors and original equipment manufacturer (OEM) partners.

The Company invented Masimo Signal Extraction Technology® (SET®), which provides the capabilities of Measure-through Motion and Low Perfusion™ pulse oximetry to address the primary limitations of conventional pulse oximetry. Over the years, the Company's product offerings have expanded significantly to also include noninvasive optical blood constituent monitoring, optical organ oximetry monitoring, electrical brain function monitoring, acoustic respiration monitoring and optical gas monitoring. The Company also developed the Root® patient monitoring and connectivity platform and the Masimo Patient SafetyNet[1] remote patient surveillance monitoring system. These solutions and related products are based upon Masimo SET®, rainbow® and other proprietary algorithms. These software-based technologies are incorporated into a variety of product platforms depending on customers' specifications. In addition, these technologies are supported by a substantial intellectual property portfolio that the Company has built through internal development, acquisitions and license agreements.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) have been condensed or omitted pursuant to such rules and regulations. The accompanying condensed consolidated financial statements have been prepared on the same basis as the annual financial statements and, in the opinion of management, reflect all adjustments, including normal recurring accruals, necessary to present fairly the Company's condensed consolidated financial statements. The accompanying condensed consolidated balance sheet as of December 31, 2016 was derived from the Company's audited consolidated financial statements at that date. The accompanying condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2016 (fiscal year 2016), filed with the SEC on February 15, 2017. The results for the six months ended July 1, 2017 are not necessarily indicative of the results to be expected for the fiscal year ending December 30, 2017 (fiscal year 2017) or for any other interim period or for any future year.

Principles of Consolidation

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

Fiscal Periods

The Company follows a conventional 52/53 week fiscal year. Under a conventional 52/53 week fiscal year, a 52 week fiscal year includes four quarters of 13 fiscal weeks while a 53 week fiscal year includes three 13 fiscal week quarters and one 14 fiscal week quarter. The Company's last 53 week fiscal year was fiscal year 2014. Fiscal year 2017 is a 52 week fiscal year. All references to years in these notes to condensed consolidated financial statements are fiscal years unless otherwise noted.

[1] The use of the trademark Patient SafetyNet is under license from the University HealthSystem Consortium.

Use of Estimates

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

Reclassifications

Certain amounts in the accompanying condensed consolidated financial statements for prior periods have been reclassified to conform to the current period presentation.

Fair Value Measurements

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

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

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

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

Pursuant to current authoritative guidance, entities are allowed an irrevocable option to elect the fair value for the initial and subsequent measurement for specified financial assets and liabilities on a contract-by-contract basis. The Company did not elect to apply the fair value option under this guidance to specific assets or liabilities on a contract-by-contract basis. There were no transfers between Level 1, Level 2 and Level 3 inputs during the six months ended July 1, 2017. The Company carries cash and cash equivalents at cost, which approximates fair value. As of July 1, 2017 and December 31, 2016, the Company did not have any short-term investments or other financial assets that were required to be measured under the fair value hierarchy.

Cash and Cash Equivalents

The Company considers all highly liquid investments with an original maturity from date of purchase of three months or less, or highly liquid investments that are readily convertible into known amounts of cash, to be cash equivalents.

Accounts Receivable and Allowance for Doubtful Accounts

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

Inventories

Inventories are stated at the lower of cost or net realizable value. Cost is determined using a standard cost method, which approximates the first in, first out method, and includes material, labor and overhead costs. Inventory reserves are recorded for inventory items that have become excess or obsolete or are no longer used in current production and for inventory items that have a market price less than carrying value in inventory.

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Property and Equipment

Property and equipment are stated at cost. Depreciation is calculated using the straight-line method over estimated useful lives as follows:

	Useful Lives
Buildings	39 years
Building improvements	7 to 15 years
Leasehold improvements	Lesser of useful life or term of lease
Machinery and equipment	5 to 7 years
Vehicles	5 years
Tooling	3 years
Computer equipment	2 to 6 years
Furniture and office equipment	2 to 6 years
Demonstration units	3 years

Land is not depreciated and construction-in-progress is not depreciated until placed in service. Normal repair and maintenance costs are expensed as incurred, whereas significant improvements that materially increase values or extend useful lives are capitalized and depreciated over the remaining estimated useful lives of the related assets. Upon sale or retirement of depreciable assets, the related cost and accumulated depreciation or amortization are removed from the accounts and any gain or loss on the sale or retirement is recognized in income.

Intangible Assets

The Company’s policy is to renew its patents and trademarks. Total renewal costs for patents and trademarks for the six months ended July 1, 2017 and July 2, 2016 were $0.1 million and $0.3 million, respectively. As of July 1, 2017, the weighted-average number of years until the next renewal was one year for patents and six years for trademarks. Costs to renew patents and trademarks are capitalized and amortized over the remaining useful life of the intangible asset. The Company continually evaluates the amortization period and carrying basis of patents and trademarks to determine whether any events or circumstances warrant a revised estimated useful life or reduction in value. Capitalized application costs are charged to operations when it is determined that the patent or trademark will not be obtained or is abandoned.

Impairment of Goodwill, Intangible Assets and Other Long-Lived Assets

Goodwill is recorded as the difference, if any, between the aggregate consideration paid for an acquisition and the fair value of the acquired net tangible and intangible assets. Goodwill is not amortized, but instead is tested annually for impairment, or more frequently when events or changes in circumstances indicate that goodwill might be impaired. In assessing goodwill impairment for each of its reporting units, the Company has the option to first assess the qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. The Company’s qualitative assessment of the recoverability of goodwill considers various macroeconomic, industry-specific and Company-specific factors, including: (i) severe adverse industry or economic trends; (ii) significant Company-specific actions; (iii) current, historical or projected deterioration of the Company’s financial performance; or (iv) a sustained decrease in the Company’s market capitalization below its net book value. If, after assessing the totality of events or circumstances, the Company determines it is unlikely that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if the Company concludes otherwise, then the Company is required to perform the first step of the two-step impairment test by comparing the fair value of the reporting unit, determined using future projected discounted operating cash flows, with its carrying amount, including goodwill. If the fair value of the reporting unit exceeds its carrying amount, goodwill is not considered impaired; otherwise, goodwill is considered impaired and the loss is measured by performing step two. Under step two, the impairment loss is measured by comparing the implied fair value of the reporting unit goodwill with the carrying amount of goodwill. The Company also has the option to bypass the qualitative assessment and proceed directly to performing the first step of the two-step goodwill impairment test. The Company may resume performing the qualitative assessment in any subsequent period. The annual impairment test is performed during the fourth fiscal quarter.

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

No impairment of goodwill, intangible assets or other long-lived assets was recorded during the three and six months ended July 1, 2017 and July 2, 2016.

Revenue Recognition and Deferred Revenue

The Company follows the current authoritative guidance for revenue recognition. Based on these requirements, the Company recognizes revenue from the sale of products or services when: (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred or services have been rendered, (iii) the price is fixed or determinable, and (iv) collectability is reasonably assured. In the case of the license or sale of software that does not function together with hardware components to provide the essential functionality of the hardware, revenue is recognized pursuant to the software revenue recognition guidance.

The Company derives the majority of its revenue from four primary sources: (i) direct sales under long-term sensor purchase agreements with end-user hospitals where the Company provides up-front monitoring equipment at no up-front charge in exchange for a multi-year sensor purchase commitment, (ii) other direct sales of noninvasive monitoring solutions to end-user hospitals, emergency medical response organizations and other direct customers; (iii) sales of noninvasive monitoring solutions to distributors who then typically resell to end-user hospitals, emergency medical response organizations and other direct customers; and (iv) sales of integrated circuit boards to OEM customers who incorporate the Company’s embedded software technology into their multiparameter monitoring devices.

The Company enters into agreements to sell its noninvasive monitoring solutions and services, sometimes as part of multiple deliverable arrangements that include various combinations of products and services. While the majority of the Company’s sales transactions contain standard business terms and conditions, there are some transactions that contain non-standard business terms and conditions. As a result, contract interpretation and analysis is sometimes required to determine the appropriate accounting, including: (i) how the arrangement consideration should be allocated among the deliverables when multiple deliverables exist, (ii) when to recognize revenue on the deliverables, and (iii) whether undelivered elements are essential to the functionality of the delivered elements. Changes in judgments on these assumptions and estimates could materially impact the timing of revenue recognition.

In the case of multiple deliverable arrangements, the authoritative guidance provides a hierarchy to determine the selling price to be used for allocating revenue to deliverables as follows: (i) vendor-specific objective evidence (VSOE) of selling price, (ii) third-party evidence of selling price (TPE), and (iii) best estimate of the selling price (ESP). VSOE of selling price is defined as the price charged when the same element is sold separately. VSOE generally exists only when the deliverable is sold separately and is the price actually charged for that deliverable. TPE generally does not exist for the majority of the Company’s products. The objective of ESP is to determine the price at which the Company would transact a sale if the product was sold on a stand-alone basis. In the absence of VSOE and TPE, the Company determines ESP for its products by considering multiple factors including, but not limited to, features and functionality of the product, geographies, type of customer, contractual prices pursuant to Group Purchasing Organization (GPO) contracts, the Company’s pricing and discount practices, and market conditions.

A deliverable in an arrangement qualifies as a separate unit of accounting if the delivered item has value to the customer on a stand-alone basis. Most of the Company’s products in a multiple deliverable arrangement qualify as separate units of accounting. In the case of the Company’s monitoring equipment containing embedded Masimo SET® or rainbow SET™ software, the Company has determined that the hardware and software components function together to deliver the equipment’s essential functionality and, therefore, represent a single deliverable. However, software deliverables, such as rainbow® parameter software, which do not function together with hardware components to provide the equipment's essential functionality, are accounted for under software revenue recognition guidance. The revenue for these multiple-element arrangements is allocated to the software deliverables and the non-software deliverables based on the relative selling prices of all of the deliverables in the arrangement using the hierarchy in the revenue recognition accounting guidance for arrangements with multiple deliverables.

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MASIMO CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(unaudited)

Sales under long-term sensor purchase contracts are generally structured such that the Company agrees to provide at no up-front charge certain monitoring-related equipment, software, installation, training and/or warranty support in exchange for the hospital's agreement to purchase sensors over the term of the agreement, which generally ranges from three to six years. These contracts generally do not provide for any payments that are not dependent upon the Company's future delivery of sensors, which are essential to the functionality of the monitoring equipment and, therefore, represent a substantive performance obligation. As a result, the Company generally does not recognize any revenue when the monitoring and related equipment and software are delivered to the hospitals, but rather recognizes revenue for these delivered elements on a pro-rata basis as the sensors are delivered under the long-term purchase commitment, when installation and training are complete. Accordingly, the cost of the monitoring and related equipment initially placed at the hospitals is deferred and amortized to cost of goods sold over the life of the underlying long-term sensor purchase contract. In cases where such contracts do provide for guaranteed payments that are unrelated to the future delivery of sensors, the Company recognizes the net present value of such payments as revenue from the monitoring and related equipment and expenses the cost of such equipment to cost of goods sold, as the equipment is delivered and when installation and training are complete. Some of the Company's long-term sensor contracts also contain provisions for certain payments to be made directly to the end-user hospital customer at the inception of the arrangement. These payments are generally treated as prepaid discounts which are deferred and amortized on a straight-line basis as contra-revenue over the life of the underlying long-term sensor purchase contract.
Many of the Company's distributors purchase sensor products that they then resell to end-user hospitals that are typically fulfilling their purchase obligations to the Company under such end-user hospital's long-term sensor purchase commitments. Upon shipment to the distributor, revenue is deferred until the distributor ships the product to the Company's end-user customers based on an estimate of the inventory held by these distributors at the end of the accounting period.
The Company also earns revenue from the sale of integrated circuit boards and other products, as well as from rainbow® parameter software licenses, to OEMs under various agreements. Revenue from the sale of products to the OEMs is generally recognized at the time of shipment. Revenue related to software licenses to OEMs is generally recognized upon shipment of the OEM's product to its customers, as represented to the Company by the OEM.
The Company also provides certain customers with the ability to purchase sensors under rebate programs. Under these programs, the customers may earn rebates based on their purchasing activity. The Company estimates and provides allowances for these programs at the time of sale as a reduction to revenue.
In general, customers do not have a right of return for credit or refund. However, the Company allows returns under certain circumstances. At the end of each period, the Company estimates and accrues for these returns as a reduction to revenue and accounts receivable. The Company estimates returns based on several factors, including contractual limitations and past returns history.
The majority of the Company's royalty and other revenue arises from an agreement with Medtronic plc (Medtronic, formerly Covidien Ltd.) that provides for quarterly royalty payments to the Company based upon U.S. sales of certain Medtronic products. An estimate of these royalty revenues is recorded quarterly in the period earned based on the prior quarter's historical results, adjusted for any new information or trends known to management at the time of estimation. This estimated revenue is adjusted prospectively when the Company receives the Medtronic royalty report, approximately sixty days after the end of the previous quarter. From time-to-time, the Company also recognizes revenue upon the achievement of pre-agreed milestones related to non-recurring engineering (NRE) services provided for certain OEM customers. Costs incurred by the Company related to these NRE services are generally deferred until such time that the milestones are achieved and the associated revenue is recognized.
Product Warranty
The Company generally provides a warranty against defects in material and workmanship for a period ranging from six to forty-eight months, depending on the product type. In traditional sales activities, including direct and OEM sales, the Company establishes an accrued liability for the estimated warranty costs at the time of revenue recognition,

with a corresponding provision to cost of sales. Customers may also purchase extended warranty coverage separately or as part of a long-term sensor purchase agreement. Revenue related to extended warranty coverage is recognized over the extended life of the contract and the related extended warranty costs are expensed as incurred.

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MASIMO CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(unaudited)

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

	Six Months Ended	
	July 1, 2017	July 2, 2016
Warranty accrual, beginning of period	$910	$1,222
Accrual for warranties issued	606	521
Changes to pre-existing warranties (including changes in estimates)	(5)	(40)
Settlements made	(485)	(488)
Warranty accrual, end of period	$1,026	$1,215

Litigation Costs and Contingencies

The Company records a charge equal to at least the minimum estimated liability for a loss contingency or litigation settlement when both of the following conditions are met: (i) information available prior to issuance of the financial statements indicates that it is probable that a liability had been incurred at the date of the financial statements, and (ii) the range of loss can be reasonably estimated. The determination of whether a loss contingency or litigation settlement is probable or reasonably possible involves a significant amount of management judgment, as does the estimation of the range of loss given the nature of contingencies. Liabilities related to litigation settlements with multiple elements are recorded based on the fair value of each element. Legal and other litigation related expenses are recognized as the services are provided. The Company records insurance and other indemnity recoveries for litigation expenses when both of the following conditions are met: (a) the recovery is probable, and (b) collectability is reasonably assured. Insurance recoveries are only recorded to the extent the litigation costs to which they relate have been incurred and recognized in the financial statements.

Comprehensive Income

Authoritative accounting guidance establishes requirements for reporting and disclosure of comprehensive income and its components. Comprehensive income includes foreign currency translation adjustments and any related tax benefits that have been excluded from net income and reflected in stockholders’ equity.

The change in accumulated other comprehensive loss was as follows (in thousands):

	Six Months Ended July 1, 2017
Accumulated other comprehensive loss, beginning of period	$(7,027)
Foreign currency translation adjustments	2,866
Accumulated other comprehensive loss, end of period	$(4,161)

Net Income Per Share

Basic net income per share is computed by dividing net income by the weighted-average number of shares outstanding during the period. Net income per diluted share is computed by dividing the net income by the weighted-average number of shares and potential shares outstanding during the period, if the effect of potential shares is dilutive. Potential shares include incremental shares of stock issuable upon the exercise of stock options and the vesting of both restricted share units (RSUs) and performance share units (PSUs). For both the three and six months ended July 1, 2017, weighted options to purchase 0.1 million shares of common stock were outstanding but not included in the computation of diluted net income per share because the effect of including such shares would have been antidilutive in the applicable period. For the three and six months ended July 2, 2016, weighted options to purchase less than 1.6 million and 1.4 million shares of common stock, respectively, were outstanding, but were not included in the computation of diluted net income per share because the effect of including such shares would have been antidilutive in the applicable period. For the three and six months ended July 1, 2017 and July 2, 2016, certain RSUs were considered contingently issuable shares as their vesting is contingent upon the occurrence of certain future events. Since such events had not occurred and were not considered probable of occurring as of July 1, 2017 and July 2, 2016, 2.7 million weighted average shares related to such RSUs have been excluded from the calculation of potential shares.

A reconciliation of basic and diluted net income per share is as follows (in thousands, except per share amounts):

	Three Months Ended		Six Months Ended	
	July 1, 2017	July 2, 2016	July 1, 2017	July 2, 2016
Net income	$46,680	$30,023	$92,014	$57,600
Basic net income per share:				
Weighted-average shares outstanding - basic	51,677	49,256	51,164	49,340
Net income per basic share	$0.90	$0.61	$1.80	$1.17
Diluted net income per share:				
Weighted-average shares outstanding - basic	51,677	49,256	51,164	49,340
Diluted share equivalent: stock options and RSUs	4,496	3,447	4,703	3,064
Weighted-average shares outstanding - diluted	56,173	52,703	55,867	52,404
Net income per diluted share	$0.83	$0.57	$1.65	$1.10

Supplemental Cash Flow Information

Supplemental cash flow information includes the following (in thousands):

	Six Months Ended	
	July 1, 2017	July 2, 2016
Cash paid during the year for:		
Interest (net of amounts capitalized)	$321	$2,603
Income taxes	81,662	19,292
Noncash investing and financing activities:		
Unpaid purchases of property, plant and equipment	$2,113	$1,168
Unsettled common stock proceeds from option exercises	237	187

Seasonality

The healthcare business in the United States and overseas is subject to quarterly fluctuations in hospital and other alternative care admissions. Historically, the Company has typically experienced higher product revenues during the traditional “flu season” that often increases hospital and acute care facility admissions in the Company’s first and fourth fiscal quarters. At the same time, the Company has frequently experienced a sequential decline in product revenues in its second and/or third fiscal quarters, primarily due to the summer vacation season during which the flu season has moderated and people tend to avoid and/or delay elective procedures. Because the Company’s non-sales variable operating expenses often do not fluctuate in the same manner as its quarterly product sales, its quarterly operating income may fluctuate disproportionately to its quarterly revenue.

Recently Issued Accounting Pronouncements

In May 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2017-09, Compensation – Stock Compensation (Topic718) : Scope of Modification Accounting (ASU 2017-09). The new standard is intended to provide clarity and reduce both (1) diversity in practice and (2) cost and complexity when applying the guidance in Accounting Standards Codification (ASC) Topic 718 to a change to the terms or conditions of a share-based payment award. The amendments in this new standard provide guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply “modification accounting” to such changes. ASU 2017-09 will become effective for all entities for annual and interim periods beginning after December 15, 2017, and early adoption is permitted. The Company is currently evaluating the expected impact of this standard, but does not expect it to have a material impact on its consolidated financial statements upon adoption.

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In January 2017, the FASB issued ASU No. 2017-04, Intangibles – Goodwill and Other (ASU 2017-04). The new standard is intended to eliminate the requirement to calculate the implied fair value of goodwill to measure a goodwill impairment charge. Instead, a goodwill impairment charge will be based on the excess of a reporting unit's carrying amount over its fair value. ASU 2017-04 is effective for annual and interim fiscal reporting periods beginning after December 15, 2019 and early adoption is permitted. The Company is currently evaluating the expected impact of this standard, but does not expect it to have a material impact on its consolidated financial statements upon adoption.

In January 2017, the FASB issued ASU No. 2017-01, Business Combinations (ASU 2017-01). The new standard is intended to clarify the definition of a business and requires an entity to evaluate if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets. If so, the set of transferred assets and activities is not considered to be a business under ASU 2017-01. ASU 2017-01 also requires a business to include at least one substantive process and narrows the definition of business outputs. The new standard will be effective on January 1, 2018, and early adoption is permitted with prospective application to any business development transaction. The Company is currently evaluating the expected impact of this standard, but does not expect it to have a material impact on its consolidated financial statements upon adoption.

In November 2016, the FASB issued ASU No. 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash (ASU 2016-18). The new standard is intended to reduce diversity in practice by adding or clarifying guidance on classification and presentation of changes in restricted cash on the statement of cash flows. ASU 2016-18 is effective for annual and interim fiscal reporting periods beginning after December 15, 2017, and early adoption is permitted. The Company is currently evaluating the expected impact of this standard, but does not expect it to have a material impact on its consolidated financial statements upon adoption.

In October 2016, the FASB issued ASU No. 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other than Inventory (ASU 2016-16). The new standard eliminates the exception that allowed the income tax consequences of an intra-entity transfer of assets other than inventory to be deferred until the transferred asset was sold to a third party or otherwise recovered through use, and now requires recognition of such income tax consequences at the time the non-inventory asset is transferred. ASU 2016-16 is effective for annual and interim fiscal reporting periods beginning after December 15, 2017, and early adoption is permitted. The Company is currently evaluating the expected impact of this standard, but does not expect it to have a material impact on its consolidated financial statements upon adoption.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (ASU 2016-15). The new standard amended the existing accounting standards for the Statement of Cash Flows and provides guidance on eight specific cash flow issues. ASU 2016-15 is effective for annual and interim fiscal reporting periods beginning after December 15, 2019, and early adoption is permitted. The Company is currently evaluating the expected impact of this standard but does not expect it to have a material impact on its consolidated financial statements upon adoption.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments (ASU 2016-13). The new standard requires entities to use a current expected credit loss model, which is a new impairment model based on expected losses rather than incurred losses. Under this model, an entity would recognize an impairment allowance equal to its current estimate of all contractual cash flows that the entity does not expect to collect. The entity's estimate would consider relevant information about past events, current conditions, and reasonable and supportable forecasts. ASU 2016-13 is effective for annual and interim fiscal reporting periods beginning after December 15, 2019, with early adoption permitted for annual reporting periods beginning after December 15, 2018. The Company is currently evaluating the expected impact of this standard but does not expect it to have a material impact on its consolidated financial statements upon adoption.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842) (ASU 2016-02). The new standard requires lessees to recognize most leases on their balance sheets but continue to recognize lease expenses in their income statement in a manner similar to current practice. The new standard states that a lessee will recognize a lease liability for the obligation to make lease payments and a right-of-use asset for the right to use the underlying asset for the lease term. Expense related to leases determined to be operating leases will be recognized on a straight-line basis, while those determined to be financing leases will be recognized following a front-loaded expense profile in which interest and amortization are presented separately in the income statement. ASU 2016-02 is effective for annual and interim fiscal reporting periods beginning after December 15, 2018, and early application is permitted. The Company is currently evaluating the expected impact of this standard on its consolidated financial statements, but anticipates that, among other things, the required recognition of a lease liability and related right-of-use asset will significantly increase both the assets and liabilities recognized and reported on its balance sheet.

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In addition, the Company anticipates that the classification of certain leases for which the Company is the lessor may change under the new guidance, resulting in the immediate expensing of certain costs that are currently deferred and expensed over the life of the lease. The Company currently expects to complete its assessment of the full financial impact of the new lease accounting guidance during the next six to twelve months and has not yet finalized any decision related to the timing of adoption for this guidance.

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities, (ASU 2016-01). The new standard requires that (i) all equity investments, other than equity-method investments, in unconsolidated entities generally be measured at fair value in net income and (ii) changes in fair value due to instrument-specific credit risk be recognized separately in other comprehensive income when the fair value option has been elected for financial liabilities. ASU 2016-01 is effective for annual and interim fiscal reporting periods beginning after December 15, 2017. The Company is currently evaluating the expected impact of this standard but does not expect it to have a material impact on its consolidated financial statements upon adoption.

In May 2014, the FASB issued ASU No. 2014-09, Revenue (Topic 606): Revenue from Contracts with Customers (ASU 2014-09). The new standard provides a single, principles-based five-step model to be applied to all contracts with customers while enhancing disclosures about revenue, providing additional guidance for transactions that were not previously addressed comprehensively and improving guidance for multiple-element arrangements. ASU 2014-09 will replace most existing revenue recognition guidance under GAAP when it becomes effective. The standard permits the use of either the retrospective or cumulative effect transition method upon adoption. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, which amended ASU 2014-09, providing for a one year deferral period for the implementation of ASU 2014-09. ASU 2014-09 will now be effective for annual and interim periods beginning on or after December 15, 2017. In March 2016, the FASB issued ASU No. 2016-08, Revenue from Contracts with Customers: Principal versus Agent Considerations under FASB ASC Topic 606, which provides guidance on principal versus agent considerations. In April 2016, the FASB issued ASU No. 2016-10, Revenue from Contracts with Customers (Topic 606) – Identifying Performance Obligations and Licensing, which amended ASU 2014-09 by providing clarity in identifying performance obligations and licensing implementation guidance. In May 2016, the FASB issued ASU No. 2016-12, Revenue from Contracts with Customers (Topic 606) – Narrow-Scope Improvements and Practical Expedients, which further amended ASU 2014-09 by providing additional clarity in recognizing revenue from contracts that have been modified prior to the transition period to the new standard, as well as providing additional disclosure requirements for businesses and other organizations that make the transition to the new standard by adjusting amounts from prior reporting periods via retrospective application. In December 2016, the FASB issued ASU No. 2016-20, Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers (ASU 2016-20). ASU 2016-20 affects narrow aspects of ASC Topic 606, including contract modifications, contract costs, and the balance sheet classification of items as contract assets versus receivables. The Company is continuing to evaluate the expected impact of the new revenue guidance contained in ASC Topic 606 on its consolidated financial statements and anticipates, among other things, that the adoption of such standard will result in the acceleration of certain revenue from product sales to distributors that is currently deferred under the “sell-through” method, as well as the capitalization and deferral of certain contract-related costs that are currently expensed when incurred. The Company currently expects to complete its assessment of the full financial impact of the new revenue recognition guidance, including the method of adoption, during the next three to five months and to adopt the guidance when it becomes effective for the Company on December 31, 2017 (fiscal year 2018).

3. Variable Interest Entity (VIE)

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

Cercacor is an independent entity that was spun off from the Company to its stockholders in 1998. Joe Kiani, the Company's Chairman and Chief Executive Officer (CEO), is also the Chairman and CEO of Cercacor. The Company is a party to a Cross-Licensing Agreement with Cercacor, which was most recently amended and restated effective January 1, 2007 (the Cross-Licensing Agreement), that governs each party's rights to certain intellectual property held by the two companies. The Company is also a party to various other agreements with Cercacor.

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MASIMO CORPORATION
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(unaudited)

As a result of changes in the capital structure of Cercacor, as well as certain of its contractual relationships with the Company, the Company completed a re-evaluation of the authoritative consolidation guidance during the first quarter of 2016 and determined that although Cercacor remained a VIE, the Company was no longer its primary beneficiary as it could no longer be deemed to have the power to direct the activities of Cercacor that most significantly impact Cercacor's economic performance and had no obligation to absorb Cercacor's losses pursuant to the Company's on-going contractual relationships with Cercacor. Based on such determination, the Company discontinued consolidating Cercacor within its consolidated financial statements effective as of January 3, 2016. However, Cercacor continues to be a related party following its deconsolidation. The Company recognized a gain of $0.3 million upon such deconsolidation, which has been reported within non-operating income in the accompanying condensed consolidated statement of operations. See Note 4 to these condensed consolidated financial statements for a description of the Company's continuing business relationships with Cercacor.

4. Related Party Transactions

The Company's Chairman and CEO is also the Chairman and CEO of Cercacor. The Company is a party to the following agreements with Cercacor:

- Cross-Licensing Agreement - The Company and Cercacor are parties to the Cross-Licensing Agreement, which governs each party's rights to certain intellectual property held by the two companies. The Company is subject to certain annual minimum aggregate royalty obligations for use of the rainbow® licensed technology. The current annual minimum royalty obligation is $5.0 million. Actual aggregate royalty liabilities to Cercacor under the license were $1.9 million and $1.6 million for the three months ended July 1, 2017 and July 2, 2016, respectively. Actual aggregate royalty liabilities to Cercacor under the license were $3.5 million and $3.1 million for the six months ended July 1, 2017 and July 2, 2016, respectively.
- Administrative Services Agreement - The Company is a party to an administrative services agreement with Cercacor (G&A Services Agreement), which governs certain general and administrative services that the Company provides to Cercacor. Amounts charged by the Company pursuant to the G&A Services Agreement were less than $0.1 million for each of the three and six months ended July 1, 2017 and July 2, 2016.
- Sublease Agreement - In March 2016, the Company entered into a sublease agreement with Cercacor for approximately 16,830 square feet of excess office and laboratory space located at 40 Parker, Irvine, California (Cercacor Sublease). The Cercacor Sublease began on May 1, 2016 and expires on November 30, 2019. The Company recognized less than $0.1 million and $0.2 million in sublease income for the three and six months ended July 1, 2017, respectively. The Company recognized less than $0.1 million in sublease income for each of the three and six months ended July 2, 2016.

Net amounts due to Cercacor at each of July 1, 2017 and December 31, 2016 were $0.6 million and $0.4 million, respectively.

The Company's CEO is also the Chairman of the Masimo Foundation for Ethics, Innovation and Competition in Healthcare (Masimo Foundation), a non-profit organization that was founded in 2010 to provide a platform for encouraging ethics, innovation and competition in healthcare. The Company's Chief Financial Officer (CFO) is also a Director of the Masimo Foundation.

The Company's CEO is the Chairman of both the Patient Safety Movement Foundation (PSMF), a non-profit organization that was founded in 2013 to work with hospitals, medical technology companies and patient advocates to unite the healthcare ecosystem and eliminate the more than 200,000 U.S. preventable hospital deaths that occur every year by 2020, and the Patient Safety Movement Coalition (PSMC), a not-for-profit social welfare organization that was founded in 2013 to promote patient safety legislation. The Company's CFO serves as the Treasurer and Secretary of PSMF, as well as the Secretary of PSMC.

The Company's CEO also serves on the board of directors of Atheer Labs, which is working with the Company on the development of next generation Root® applications, and the board of directors of Children's Hospital of Orange County and CHOC Children's at Mission Hospital, two non-profit hospitals devoted exclusively to caring for children, both of which are also customers of the Company.

MASIMO CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(unaudited)

5. Inventories
Inventories consist of the following (in thousands):

	July 1, 2017	December 31, 2016
Raw materials	$42,562	$ 32,647
Work-in-process	6,755	7,701
Finished goods	39,141	