MEDTRONIC INC
Form 10-Q
December 05, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

x **QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended October 27, 2006

Commission File Number 1-7707

MEDTRONIC, INC.

(Exact name of registrant as specified in its charter)

Minnesota	**41-0793183**
(State of incorporation)	(I.R.S. Employer Identification No.)

710 Medtronic Parkway

Minneapolis, Minnesota 55432

(Address of principal executive offices)

Telephone number: **(763) 514-4000**

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 o

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

Large accelerated filer x Accelerated filer o Non-accelerated filer o

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

Shares of common stock, $.10 par value, outstanding on November 30, 2006: **1,151,133,193**

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

MEDTRONIC, INC.

CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

(Unaudited)

	Three months ended		Six months ended	
	October 27, 2006	**October 28, 2005**	**October 27, 2006**	**October 28, 2005**
	(in millions, except per share data)			
Net sales	$3,075	$2,765	$5,972	$5,456
Costs and expenses:				
Cost of products sold	795	695	1,527	1,349
Research and development expense	320	275	619	538
Selling, general and administrative expense	1,036	903	2,020	1,786
Special charges		100		100
Certain litigation charges			40	
Purchased in-process research and development (IPR&D)				364
Other expense, net	50	41	116	91
Interest income, net	(37)	(14)	(76)	(29)
Total costs and expenses	2,164	2,000	4,246	4,199
Earnings before income taxes	911	765	1,726	1,257
Provision for income taxes	230	(52)	446	120
Net earnings	$681	$817	$1,280	$1,137
Earnings per share:				
Basic	$0.59	$0.68	$1.11	$0.94
Diluted	$0.59	$0.67	$1.10	$0.93
Weighted average shares outstanding:				
Basic	1,149.3	1,208.6	1,151.4	1,209.6
Diluted	1,159.4	1,222.5	1,161.9	1,222.4

See accompanying notes to the condensed consolidated financial statements.

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MEDTRONIC, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	October 27, 2006	April 28, 2006
	(in millions, except per share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$1,090	$2,994
Short-term investments	2,515	3,107
Accounts receivable, less allowances of $194 and $184, respectively	2,590	2,429
Inventories	1,318	1,177
Deferred tax assets, net	414	197
Prepaid expenses and other current assets	496	473
Total current assets	8,423	10,377
Property, plant and equipment	4,048	3,794
Accumulated depreciation	(2,100)	(1,913)
Net property, plant and equipment	1,948	1,881
Goodwill	4,361	4,346
Other intangible assets, net	1,608	1,592
Long-term investments	2,056	957
Long-term deferred tax assets, net	12	
Other long-term assets	488	512
Total assets	$18,896	$19,665
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Short-term borrowings	$529	$2,437
Accounts payable	319	319
Accrued compensation	622	723
Accrued income taxes	696	461
Other accrued expenses	529	466
Total current liabilities	2,695	4,406
Long-term debt	5,581	5,486
Long-term deferred tax liabilities, net		22
Long-term accrued compensation	186	189

Other long-term liabilities	157	179
Total liabilities	8,619	10,282
Commitments and contingencies (Note 15)		
Shareholders equity:		
Preferred stock par value $1.00		
Common stock par value $0.10	115	116
Retained earnings	9,960	9,112
Accumulated other non-owner changes in equity	202	155
Total shareholders equity	10,277	9,383
Total liabilities and shareholders equity	$ 18,896	$ 19,665

See accompanying notes to the condensed consolidated financial statements.

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MEDTRONIC, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Six months ended	
	October 27, 2006	**October 28, 2005**
	(dollars in millions)	
OPERATING ACTIVITIES:		
Net earnings	$ 1,280	$ 1,137
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	277	268
Purchased in-process research and development		364
Provision for doubtful accounts	21	4
Deferred income taxes	(251)	192
Stock-based compensation	94	12
Excess tax benefit from exercise of stock-based awards	(11)	
Change in operating assets and liabilities:		
Accounts receivable	(179)	(74)
Inventories	(143)	(189)
Accounts payable and accrued liabilities	199	(740)
Other operating assets and liabilities	20	45
Net cash provided by operating activities	1,307	1,019
INVESTING ACTIVITIES:		

Acquisitions, net of cash acquired	(8)	(285)
Purchase of intellectual property	(102)	(794)
Additions to property, plant and equipment	(251)	(229)
Purchases of marketable securities	(7,275)	(1,922)
Sales and maturities of marketable securities	6,787	1,013
Other investing activities, net	(44)	(12)
Net cash used in investing activities	(893)	(2,229)
FINANCING ACTIVITIES:		
Change in short-term borrowings, net	63	386
Increase in long-term debt, net	1	994
Payments on long-term debt	(1,877)	
Dividends to shareholders	(254)	(232)
Issuance of common stock	113	254
Excess tax benefit from exercise of stock-based awards	11	
Repurchase of common stock	(398)	(564)
Net cash (used in) provided by financing activities	(2,341)	838
Effect of exchange rate changes on cash and cash equivalents	23	88
Net change in cash and cash equivalents	(1,904)	(284)
Cash and cash equivalents at beginning of period	2,994	2,232
Cash and cash equivalents at end of period	$1,090	$1,948
Supplemental Cash Flow Information		
Cash Paid For:		
Income taxes	$462	$106
Interest	112	44
Supplemental Noncash Investing and Financing Activities:		
Deferred payments for purchases of intellectual property	$	$30
Reclassification of debentures from long-term to short-term debt		1,971
Reclassification of debentures from short-term to long-term debt	94	

See accompanying notes to the condensed consolidated financial statements.

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MEDTRONIC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1   Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S.) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information necessary for a fair presentation of results of operations, financial condition, and cash flows in conformity with accounting principles generally accepted in the U.S. In the opinion of management, the condensed consolidated financial statements reflect all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of the results of Medtronic, Inc. and its subsidiaries (Medtronic or the Company) for the periods presented. Operating results for interim periods are not necessarily indicative of results that may be expected for the fiscal year as a whole. The preparation of the financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses, and the related disclosures at the date of the financial statements and during the reporting period. Actual results could materially differ from these estimates. For further information, refer to the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended April 28, 2006.

Note 2 Stock-Based Compensation

Effective April 29, 2006, the Company adopted the provisions of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment (SFAS No. 123(R)) which replaced SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No. 123) and supersedes Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees (APB Opinion No. 25). Under the fair value recognition provisions of SFAS No. 123(R), the Company measures stock-based compensation cost at the grant date based on the fair value of the award and recognizes the compensation expense over the requisite service period, which is generally the vesting period. The Company elected the modified-prospective method of adopting SFAS No. 123(R), under which prior periods are not retroactively restated. The provisions of SFAS No. 123(R) apply to awards granted after the April 29, 2006 effective date. Stock-based compensation expense for non-vested awards granted prior to the effective date is being recognized over the remaining service period using the fair-value based compensation cost estimated for SFAS No. 123 pro forma disclosures. Total stock-based compensation expense included in our statement of earnings for the three and six months ended October 27, 2006 was $44 million ($32 million net of tax) and $94 million ($65 million net of tax), respectively.

Stock Options

Stock options awards are granted at exercise prices equal to the closing price of the Company s common stock on the grant date. The majority of the Company s stock option awards are non-qualified stock options with a ten-year life and a four-year ratable vesting term. The Company currently grants stock options under the Medtronic, Inc. 2003 Long-Term Incentive Plan (2003 Plan) and the Medtronic, Inc. 1998 Outside Directors Stock Compensation Plan (Directors Plan). As of October 27, 2006, there were approximately 32 million and 2 million shares available for future grants under each of these plans, respectively.

Restricted Stock Awards

Restricted stock and restricted stock units, collectively restricted stock awards, are granted to officers and key employees. Restricted stock awards are subject to forfeiture if employment terminates prior to the lapse of the restrictions. The Company grants restricted stock awards that typically cliff vest between three- and five-year periods. Shares of restricted stock are considered issued and outstanding shares of the Company at the grant date and have the same dividend and voting rights as other common stock. Restricted stock units are not considered issued or outstanding common stock of the Company. Dividend equivalent units are accumulated on restricted stock units during the vesting period. The Company grants restricted stock awards under the 2003 Plan and the Directors Plan.

Employee Stock Purchase Plan

The Medtronic, Inc. 2005 Employee Stock Purchase Plan (ESPP) allows participating employees to purchase shares of the Company s common stock at a discount through payroll deductions. Employees can contribute up to the lesser of 10% of their wages or the statutory limit under the U.S. Internal Revenue Code toward the purchase of the Company s common stock at 85% of its market value at the end of the calendar quarter purchase period. Employees purchased 1 million shares at an average price of $39.72 per share in the six months ended October 27, 2006. As of October 27, 2006, plan participants have had approximately $5 million withheld to purchase Company common stock at 85% of its market value on December 29, 2006, the last trading day before the end of the calendar quarter purchase period. At October 27, 2006, approximately 8 million shares of common stock were available for future purchase under the ESPP.

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Valuation Assumptions

The Company uses the Black-Scholes option pricing model (Black-Scholes model) to determine the fair value of stock options as of the grant date. The fair value of stock options under the Black-Scholes model requires management to make assumptions regarding projected employee stock option exercise behaviors, risk-free interest rates, volatility of the Company s stock price and expected dividends.

The expense recognized for shares purchased under our ESPP is equal to the 15% discount the employee receives at the end of the calendar quarter purchase period. The fair value of restricted stock awards equals the Company s closing stock price on the date of grant.

The following table provides the weighted average fair value of options granted to employees and the related assumptions used in the Black-Scholes model:

	Three Months Ended		Six Months Ended	
	October 27, 2006	**October 28, 2005**	**October 27, 2006**	**October 28, 2005**
Weighted Average Fair Value of options granted	$11.16	$14.42	$11.24	$14.15
Assumptions used:				
Expected life (years)[a]	4.48	4.61	4.49	4.61
Risk-free interest rate [b]	4.77%	4.09%	4.77%	3.98%
Volatility [c]	21.3%	25.0%	21.4%	25.0%
Dividend yield [d]	0.95%	0.71%	0.95%	0.72%

(a) *Expected life*: The Company analyzes historical employee exercise and termination data to estimate the expected life assumption. The Company believes that historical data currently represents the best estimate of the expected life of a new employee option. The Company examined its historical pattern of option exercises and determined that relative to the employee population as a whole, management employees held their stock options longer prior to exercising compared to the rest of the employee population. Therefore, the Company stratifies its employee population based upon these distinctive exercise behavior patterns. Prior to adopting SFAS No.

123(R), the Company used the entire employee population for estimating the expected life assumptions.

(b) *Risk-free interest rate*: The rate is based on the U.S. Treasury zero-coupon yield curve on the grant date for a maturity similar to the expected life of the options.

(c) *Volatility*: The expected volatility of the Company s common stock is calculated by using the historical daily volatility of the Company s stock price calculated over a period of time representative of the expected life of the options.

(d) *Dividend yield*: The dividend yield rate is calculated by dividing the Company s annual dividend, based on the most recent quarterly dividend rate, by the closing stock price on the grant date.

Stock-Based Compensation Expense

Prior to adopting SFAS No. 123(R), the Company accounted for stock options under APB Opinion No. 25 using the intrinsic value method and the impact based on the fair value method on the Company s net earnings was disclosed on a pro forma basis in the notes to the consolidated financial statements. In these pro forma disclosures, the Company recognized stock option compensation expense based on the stated vesting period, rather than the time to achieve retirement eligibility. Upon adopting SFAS No. 123(R), the Company changed its method of recognition and now recognizes stock option compensation expense based on the substantive vesting period for all new awards. Compensation expense related to stock options granted prior to fiscal year 2007 that are subject to accelerated vesting upon retirement eligibility is being recognized over the stated vesting term of the grant. If the Company had historically accounted for stock-based awards made to retirement eligible individuals under the requirements of SFAS No. 123(R), the pro forma expense disclosed below would have been decreased by $3 million and $7 million for the three and six months ended October 28, 2005, respectively. There was no stock-based compensation expense capitalized as it was deemed immaterial.

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The amount of stock-based compensation expense recognized during a period is based on the portion of the awards that are ultimately expected to vest. The Company estimates pre-vesting forfeitures at the time of grant by analyzing historical data and revises those estimates in subsequent periods if actual forfeitures differ from those estimates. Ultimately, the total expense recognized over the vesting period will equal the awards that actually vest.

The following table presents the statement of earnings classification of pre-tax stock-based compensation expense, for options and restricted stock awards, recognized for the three and six months ended October 27, 2006:

(dollars in millions)	**Three months ended October 27, 2006**	**Six months ended October 27, 2006**
Cost of sales	$4	$10
Research and development expense	10	22
Selling, general and administrative expense	30	62

$44	$94

The following table illustrates the effect on net earnings and net earnings per share for the three and six months ended October 28, 2005 if the Company had applied the fair value recognition provisions of SFAS No. 123 to its stock-based employee compensation:

(dollars in millions, except per share amounts)	**Three months ended October 28, 2005**	**Six months ended October 28, 2005**
Net earnings, as reported	$817	$1,137
Add: Stock-based compensation expense included in net earnings [1]	4	8
Less: Stock-based compensation expense determined under fair value based method for all awards [1]	(30)	(65)
Pro forma net earnings	$791	$1,080
Basic earnings per share:		
As reported	$0.68	$0.94
Pro forma	$0.65	$0.89
Diluted earnings per share:		
As reported	$0.67	$0.93
Pro forma	$0.65	$0.89

(1) Compensation expense is net of related tax effects

Tax Impacts of Stock-Based Compensation

Prior to the adoption of SFAS No. 123(R), benefits of tax deductions in excess of recognized share-based compensation expense were reported on the consolidated statement of cash flows as operating cash flows. Under SFAS No. 123(R), such excess tax benefits are reported as financing cash flows. Although total cash flows under SFAS No. 123(R) remain unchanged from what would have been reported under prior accounting standards, net operating cash flows are reduced and net financing cash flows are increased due to the adoption of SFAS No. 123(R). For the six months ended October 27, 2006, there were excess tax benefits of $11 million, which are classified as financing cash flows. For the six months ended October 28, 2005, there were excess tax benefits of $66 million, respectively, which were classified as operating cash flows as part of the change in *accounts payable and accrued liabilities*.

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Stock Options

The following table summarizes stock option activity during the six months ended October 27, 2006:

	Options (in thousands)	Weighted Average Exercise Price
Outstanding at April 28, 2006	88,838	$46.23
Granted	2,383	47.71
Exercised	(1,305)	35.97
Canceled/Forfeited	(1,448)	49.51
Outstanding at October 27, 2006	88,468	$46.36

A summary of stock options as of October 27, 2006, including options issued as a result of acquisitions from fiscal year 2002 and prior, is as follows:

			Options Outstanding			Options Exercisable	
Ranges of Exercise Prices			Options (in thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (years)	Options (in thousands)	Weighted Average Exercise Price
$	0.01	10.00	82	$ 5.33	0.5	82	$ 5.33
	10.01	20.00	1,004	16.48	0.8	1,004	16.48
	20.01	30.00	3,052	24.61	1.3	3,052	24.61
	30.01	40.00	8,163	34.53	2.9	8,147	34.52
	40.01	50.00	51,106	46.32	6.4	44,675	46.23
	50.01	69.82	25,061	54.30	7.1	14,269	53.32
$	0.01	69.82	88,468	$ 46.36	6.0	71,228	$ 44.92

The total intrinsic value of options exercised during the six months ended October 27, 2006 was $17 million. The total intrinsic value, calculated as the closing stock price at the end of the second quarter less the option exercise price of in the money options, for options outstanding and exercisable at October 27, 2006 was $361 million and $348 million, respectively. The Company issues new shares when stock option awards are exercised. Cash received from the exercise of stock options for the six months ended October 27, 2006 was $46 million and the related tax benefits realized was $11 million. Unrecognized compensation expense related to outstanding stock options as of October 27, 2006 was $212 million, pre-tax, and is expected to be recognized over a weighted average period of 2.6 years and will be adjusted for any future changes in estimated forfeitures.

Restricted Stock Awards

The following table summarizes restricted stock award activity during the six months ended October 27, 2006:

	Awards (in thousands)	Weighted Average Grant Price
Nonvested, April 28, 2006	2,008	$ 51.64
Granted	979	46.85
Reinvested dividend equivalent units	3	50.09

Vested	(15)		47.44
Forfeited	(42)		52.93
Nonvested, October 27, 2006	2,933	$	50.87

Unrecognized compensation expense related to restricted stock awards as of October 27, 2006 was $87 million, pre-tax, and is expected to be recognized over a weighted average period of 4.1 years and will be adjusted for any future changes in estimated forfeitures.

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Note 3 New Accounting Pronouncements

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109, Accounting for Income Taxes (FIN No. 48). FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109. FIN No. 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN No. 48 is effective for the Company beginning with fiscal year 2008, with earlier adoption permitted. The Company is currently evaluating the impact that the adoption of FIN No. 48 will have on its consolidated financial statements.

In September 2006, the FASB issued Statement No. 157, Fair Value Measurements. Statement No. 157 establishes a framework for measuring fair value in accordance with generally accepted accounting principles, clarifies the definition of fair value within that framework, and expands disclosures about fair value measurements. SFAS 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value, except for the measurement of share based payments. The standard does not expand the use of fair value in any new circumstances. SFAS 157 is effective, for the Company, beginning fiscal first quarter 2009. For certain types of financial instruments, SFAS 157 requires a limited form of retrospective transition, whereby the cumulative impact of the change in principle is recognized in the opening balance in retained earnings in the fiscal year of adoption. All other provisions of SFAS 157 will be applied prospectively beginning in fiscal first quarter 2009. The Company is currently evaluating the impact that the adoption of SFAS No. 157 will have on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans. SFAS No. 158 requires the recognition of the funded status of a benefit plan in the balance sheet; the recognition in other comprehensive income of gains or losses and prior service costs or credits arising during the period but which are not included as components of periodic benefit cost; the measurement of defined benefit plan assets and obligations as of the balance sheet date; and disclosure of additional information about the effects on periodic benefit cost for the following fiscal year arising from delayed recognition in the current period. In addition, SFAS No. 158 amends SFAS No. 87, Employers Accounting for Pensions, and SFAS No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions, to include guidance regarding selection of assumed discount rates for use in measuring the benefit obligation. SFAS No. 158 is effective for the Company s fiscal year ending April 27, 2007. The Company is currently evaluating the impact that the adoption of SFAS No. 158 will have on its consolidated financial statements.

Note 4 Acquisitions and IPR&D Charges, Certain Litigation Charges and Special Charges

The values assigned to purchased in-process research and development (IPR&D) are based on valuations that have been prepared using methodologies and valuation techniques consistent with those used by independent appraisers. All values were determined by identifying research projects in areas for which technological feasibility had not been established. Additionally, the values were determined by estimating the revenue and expenses associated with a project s sales cycle and the amount of after-tax cash flows attributable to these projects. The future cash flows were discounted to present value utilizing an appropriate risk-adjusted rate of return. The rate of return included a factor that takes into account the uncertainty surrounding the successful development of the IPR&D.

At the time of acquisition, the Company expects all acquired IPR&D will reach technological feasibility, but there can be no assurance that the commercial viability of these products will actually be achieved. The nature of the efforts to develop the acquired technologies into commercially viable products consists principally of planning, designing and conducting clinical trials necessary to obtain regulatory approvals. The risks associated with achieving commercialization include, but are not limited to, delay or failure to obtain regulatory approvals to conduct clinical trials, delay or failure to obtain required market clearances, and patent issuance, validity and litigation, if any. If commercial viability were not achieved, the Company would likely look to other alternatives to provide these therapies.

Acquisitions and IPR&D charges:

On September 15, 2006, the Company acquired and/or licensed selected patents and patent applications owned by Dr. Eckhard Alt (Dr. Alt), or certain of his controlled companies in a series of transactions. In connection therewith, the Company also resolved all outstanding litigation and disputes between Dr. Alt and itself and its affiliates. The agreements required the payment of total consideration of $75 million, $74 million of which was capitalized as technology based intangible assets that have an estimated useful life of 11 years. The acquired patents or licenses pertain to the cardiac rhythm disease management field and have both current application and potential for future patentable commercial products.

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On July 25, 2006, the Company acquired substantially all of the assets of Odin Medical Technologies, LTD (Odin), a privately held company. Prior to the acquisition, the Company had an equity investment in Odin, which was accounted for under the cost method of accounting. Odin focused on the manufacture of the PoleStar intraoperative Magnetic Resonance Image (iMRI) Guidance System which was already exclusively distributed by the Company. This acquisition is expected to help the Company further drive the acceptance of iMRI guidance in neurosurgery.

The consideration for Odin was approximately $21 million, which included $6 million in upfront cash and a $2 million milestone payment made in the three months ended October 27, 2006. The $8 million in net cash paid resulted from the $21 million in consideration less the value of the Company s prior investment in Odin and Odin s existing cash balance.

In connection with the acquisition of Odin, the Company acquired $9 million of technology-based intangible assets that have an estimated useful life of 12 years. Goodwill of $12 million related to the acquisition was assigned entirely to the Spinal and Navigation operating segment. This goodwill is deductible for tax purposes.

The pro forma impact of Odin was not significant to the results of the Company for the three months ended October 27, 2006 or October 28, 2005. The results of operations related to Odin have been included in the Company s condensed consolidated statements of earnings since the date of the acquisition.

On July 1, 2005, the Company acquired all of the outstanding stock of Transneuronix, Inc. (TNI), a privately held company. Prior to the acquisition, the Company had an equity investment in TNI, which was accounted for under the cost method of accounting. TNI focused on the treatment of obesity by stimulation of the stomach with an implantable gastric stimulator, known as the Transcend device. This acquisition is expected to complement the Company s formation of a new business unit, Emerging Therapies, and the Company s strategy to deliver therapeutic solutions for the worldwide challenges of obesity. Emerging Therapies is part of the Neurological operating segment.

The consideration for TNI was approximately $269 million, which included $227 million in net cash paid. The $227 million in net cash paid resulted from the $269 million in consideration less the value of the Company s prior investment in TNI and TNI s existing cash balance. The purchase price is subject to increases which would be triggered by the achievement of certain milestones.

As a result of the acquisition of TNI, the Company acquired $55 million of intangible assets of which $54 million are technology-based intangible assets that have an estimated useful life of 15 years and $169 million of IPR&D that was expensed on the date of acquisition related to a product being developed for the treatment of obesity by stimulation of the stomach that had not yet reached technological feasibility and for which no future alternative use had been identified. Goodwill of $51 million related to the acquisition was assigned entirely to the Neurological operating segment. This goodwill is not deductible for tax purposes.

The following table summarizes the allocation of the purchase price to the estimated fair values of the assets acquired and liabilities assumed (dollars in millions):

Current assets	$	13
Other intangible assets		55
IPR&D		169
Goodwill		51
Total assets acquired		288
Current liabilities		14
Deferred tax liability long term		5
Total liabilities assumed		19
Net assets acquired	$	269

The pro forma impact of TNI was not significant to the results of the Company for the three months ended July 29, 2005. The results of operations related to TNI have been included in the Company s condensed consolidated statements of earnings since the date of the acquisition.

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On May 18, 2005, the Company acquired substantially all of the spine-related intellectual property and related contracts, rights, and tangible materials owned by Gary Michelson, M.D. and Karlin Technology, Inc. (Michelson) and settled all outstanding litigation and disputes between Michelson and the Company. The acquired patents pertain to novel spinal technology and techniques that have both current application and the potential for future patentable commercial products. The agreement requires the payment of total consideration of $1.350 billion for (i) the purchase of a portfolio of more than 100 issued U.S. patents, (ii) over 110 pending U.S. patent applications and numerous foreign counterparts to these patents and patent applications, and (iii) the settlement of all litigation. A value of $550 million was assigned to the settlement of past damages between the parties and was recorded as an expense in fiscal fourth quarter 2005. The remaining consideration, including $3 million of direct acquisition costs, was allocated between $628 million of acquired technology based intangible assets that have an estimated useful life of 17 years and $175 million of IPR&D that was expensed on the date of acquisition related to spinal technology based devices that had not yet reached technological feasibility and had no future alternative use. The patents pertain to novel spinal technology and techniques that have the potential for future patentable commercial products in the area of spinal surgery. During fiscal first quarter 2006, the Company paid $1.320 billion and committed to three future installments of $10 million to be paid in May 2006, 2007, and 2008. The first installment of $10 million was paid in May 2006.

During fiscal first quarter 2006, the Company also entered into a royalty bearing, non-exclusive patent cross-licensing agreement with NeuroPace, Inc. Under the terms of the agreement, the two companies cross-licensed patents and patent applications of neurological technology related to direct electrical stimulation or monitoring of the brain. On the date of the agreement, $20 million was expensed as IPR&D related to the licensed technology since technological feasibility of the project had not yet been reached and such technology had no future alternative use. This licensed technology is expected to enhance the Company s ability to further develop and expand its therapies for neurological disorders.

Certain litigation charges:

During the six months ended October 27, 2006, the Company reached a settlement agreement with the United States Department of Justice which requires the government to obtain dismissal of the two qui tam civil suits and is conditional upon such dismissal being obtained. To resolve the matter, Medtronic has entered into a five-year agreement that further strengthens its employee training and compliance systems surrounding sales and marketing practices. The settlement agreement also reflects Medtronic s assertion that the Company and its current employees had not engaged in any wrongdoing or illegal activity. Medtronic also agreed to pay $40 million pending dismissal of the related lawsuits, and has recorded an expense in that amount in fiscal first quarter 2007.

There were no certain litigation charges during the three and six months ended October 28, 2005.

Special charges:

There were no special charges during the three and six months ended October 27, 2006.

In fiscal second quarter 2006, the Company recorded a $100 million pre-tax charitable donation to The Medtronic Foundation, which is a related party non-profit organization. The donation to The Medtronic Foundation was paid in fiscal second quarter 2006.

Contingent Consideration

Certain of the Company s business combinations involve the potential for the payment of future contingent consideration upon the achievement of certain product development milestones and/or various other favorable operating conditions. While it is not certain if and/or when these payments will be made, the Company has developed an estimate of the potential contingent consideration for each of its acquisitions with an outstanding potential obligation. At October 27, 2006, the estimated potential amount of future contingent consideration that the Company is expected to make associated with all business combinations is approximately $59 million. The milestones associated with the contingent consideration must be reached in future periods ranging from fiscal years 2006 to 2012 in order for the consideration to be paid.

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Note 5 Inventories

Inventories are stated at the lower of cost or market, with cost determined on a first-in, first-out basis. Inventory balances are as follows (dollars in millions):

	October 27, 2006	**April 28, 2006**
Finished goods	$824	$736
Work in process	215	197
Raw materials	279	244
Total	$1,318	$1,177

Note 6 Goodwill and Other Intangible Assets

The changes in the carrying amount of goodwill for the six months ended October 27, 2006 are as follows (dollars in millions):

	October 27, 2006
Balance at April 28, 2006	$4,346
Goodwill as a result of acquisitions	16
Currency adjustment, net	(1)
Balance at October 27, 2006	$4,361

Intangible assets, excluding goodwill, as of October 27, 2006 and April 28, 2006 are as follows (dollars in millions):

	Purchased Technology and Patents	Trademarks and Tradenames	Other	Total
As of October 27, 2006:				
Amortizable intangible assets				
Original cost	$1,867	$265	$222	$2,354
Accumulated amortization	(485)	(137)	(124)	(746)
Carrying value	$1,382	$128	$98	$1,608
As of April 28, 2006:				
Amortizable intangible assets				
Original cost	$1,761	$265	$230	$2,256
Accumulated amortization	(423)	(124)	(117)	(664)
Carrying value	$1,338	$141	$113	$1,592

Amortization expense for the three and six months ended October 27, 2006 was approximately $45 million and $90 million, respectively, and for the three and six months ended October 28, 2005 was approximately $44 million and $85 million, respectively.

Estimated aggregate amortization expense based on the current carrying value of amortizable intangible assets is as follows (dollars in millions):

Fiscal Year	Amortization Expense
Remaining 2007	$ 92
2008	180
2009	172
2010	164
2011	152
Thereafter	848
	$ 1,608

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Note 7 Warranty Obligation

The Company offers a warranty on various products. The Company estimates the costs that may be incurred under its warranties and records a liability in the amount of such costs at the time the product is sold. Factors that affect the Company s warranty liability include the number of units sold, historical and anticipated rates of warranty claims and cost per claim. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary. The amount of the reserve recorded is equal to the costs to repair or otherwise satisfy the claim.

Changes in the Company s product warranties during the six months ended October 27, 2006 and October 28, 2005 consisted of the following (dollars in millions):

	Six Months Ended	
	October 27, 2006	**October 28, 2005**
Balance at the beginning of the period	$41	$43
Warranty claims provision	13	27
Settlements made	(18)	(27)
Balance at the end of the period	$36	$43

Note 8 Financing Arrangements

Senior Convertible Notes

In April 2006, the Company issued $2.200 billion of 1.500% Senior Convertible Notes due 2011 and $2.200 billion of 1.625% Senior Convertible Notes due 2013 (collectively, the Senior Convertible Notes). The Senior Convertible Notes were issued at par and pay interest in cash semi-annually in arrears on April 15 and October 15 of each year. The Senior Convertible Notes are unsecured unsubordinated obligations and rank equally with all other unsecured and unsubordinated indebtedness. The Senior Convertible Notes have an initial conversion price of $56.14 per share. The Senior Convertible Notes may only be converted: (i) during any calendar quarter if the closing price of the Company s common stock reaches 140% of the conversion price for 20 trading days during a specified period, or (ii) if specified distributions to holders of the Company s common stock are made or specified corporate transactions occur, or (iii) during the last month prior to maturity of the applicable notes. Upon conversion, a holder would receive: (i) cash equal to the lesser of the principal amount of the note or the conversion value and (ii) to the extent the conversion value exceeds the principal amount of the note, shares of the Company s common stock, cash, or a combination of common stock and cash, at the Company s option. In addition, upon a change in control, as defined, the holders may require the Company to purchase for cash all or a portion of their notes for 100% of the principal amount of the notes plus accrued and unpaid interest, if any, plus a number of additional make-whole shares of the Company s common stock, as set forth in the applicable indenture. The indentures under which the Senior Convertible Notes were issued contain customary covenants. A total of $2.500 billion of the net proceeds from these note issuances were used to repurchase common stock under the Company s stock repurchase program.

Concurrent with the issuance of the Senior Convertible Notes, the Company purchased call options on its common stock in private transactions. The call options allow the Company to receive shares of the Company s common stock and/or cash from counterparties equal to the amounts of common stock and/or cash related to the excess conversion value that it would pay to the holders of the Senior Convertible Notes upon conversion. These call options will terminate upon the earlier of the maturity dates of the related Senior Convertible Notes or the first day all of the related Senior Convertible Notes are no longer outstanding due to conversion or otherwise. The call options, which cost an aggregate $1.075 billion ($699 million net of tax benefit), were recorded as a reduction of shareholders equity.

In separate transactions, the Company sold warrants to issue shares of the Company s common stock at an exercise price of $76.56 per share in private transactions. Pursuant to these transactions, warrants for 41 million shares of the Company s common stock may be settled over a specified period beginning in July 2011 and warrants for 41 million shares of the Company s common stock may be settled over a specified period beginning in July 2013 (the settlement dates). If the average price of the Company s common stock during a defined period ending on or about the respective settlement dates exceeds the exercise price of the warrants, the warrants will be settled in shares of the Company s common stock. Proceeds received from the issuance of the warrants totaled approximately $517 million and were recorded as an addition to shareholders equity.

Senior Notes

In September 2005, the Company issued two tranches of Senior Notes with the aggregate face value of $1.000 billion. The first tranche consisted of $400 million of 4.375% Senior Notes due 2010 and the second tranche consisted of $600 million of 4.750% Senior Notes due 2015. Each tranche was issued at a discount which resulted in an effective interest rate of 4.433% and 4.760% for the five and ten year Senior Notes, respectively. Interest on each series of Senior Notes is payable semi-annually, on March 15 and September 15 of each year. The Senior Notes are unsecured unsubordinated obligations of the Company and rank equally with all other unsecured and unsubordinated indebtedness of the Company. The indentures under which Senior Notes were issued contain customary covenants. The Company used the net proceeds from the sale of the Senior Notes for repayment of a portion of its commercial paper.

In November 2005, the Company entered into a five year interest rate swap agreement with a notional amount of $200 million. This interest rate swap agreement was designated as a fair value hedge of the changes in fair value of a portion of the Company s fixed-rate $400 million Senior Notes due 2010. The Company pays variable interest equal to the three-month London Interbank Offered Rate (LIBOR) minus 55 basis points and it receives a fixed interest rate of 4.375%.

Contingent Convertible Debentures

In September 2001, the Company completed a $2.013 billion private placement of 1.25% Contingent Convertible Debentures due September 2021 (Old Debentures). Interest is payable semi-annually. Each Old Debenture is convertible into shares of common stock at an initial conversion price of $61.81 per share; however, the Old Debentures are not convertible before their final maturity unless the closing price of our common stock reaches 110% of the conversion price for 20 trading days during a consecutive 30 trading day period.

In September 2002 and 2004, as a result of certain holders of the Old Debentures exercising their put options, the Company repurchased $39 million and $1 million respectively, of the Old Debentures for cash.

On January 24,2005, the Company completed an exchange offer whereby holders of approximately $1.930 billion of the total principal amount of the Old Debentures exchanged their existing securities for an equal principal amount of 1.25% Contingent Convertible Debentures, Series B due 2021 (New Debentures), as described below. Following the completion of the exchange offer, the Company repurchased approximately $2 million of the Old Debentures for cash.

The terms of the New Debentures are consistent with the terms of the Old Debentures noted above, except that: (i) the New Debentures require the Company to settle all conversions for a combination of cash and shares of our common stock, if any, in lieu of only shares. Upon conversion of the New Debentures the Company will pay holders cash equal to the lesser of the principal amount of the New Debentures or their conversion value, and shares of the Company s common stock to the extent the conversion value exceeds the principal amount of the New Debentures; and (ii) the New Debentures require the Company to pay only cash (in lieu of shares of our common stock or a combination of cash and shares of our common stock) when the Company repurchases the New Debentures at the option of the holder or when the Company repurchases the New Debentures in connection with a change of control.

In September 2006, as a result of certain holders of the New Debentures and Old Debentures exercising their put options, the Company repurchased $1.835 billion of the New Debentures for cash and $42 million of the Old Debentures for cash. Twelve months prior to the put options becoming exercisable, the remaining balance of the New Debentures and the Old Debentures will be classified as *short-term borrowings.* At each balance sheet date without a put option within the subsequent four quarters, the remaining balance will be classified as *long-term debt.* Accordingly, during the second quarter of fiscal year 2007, $93 million of New Debentures and $1 million of the Old Debentures were reclassified from *short-term borrowings* to *long-term debt* as a result of the September 2006 put option expiring. For put options exercised by the holders of the New Debentures and the Old Debentures, the purchase price is equal to the principal amount of the applicable debenture plus any accrued and unpaid interest thereon to the repurchase date. If the put option is exercised, the Company will pay holders the repurchase price solely in cash (or, for the Old Debentures, in cash or stock at our option). The Company may be required to repurchase the remaining debentures at the option of the holders in September 2008, 2011 or 2016. As of October 27, 2006, approximately $93 million aggregate principal amount of New Debentures remain outstanding and approximately $1 million aggregate principal amount of Old Debentures remain outstanding. The Company can redeem the debentures for cash at any time.

Commercial Paper

We maintain a commercial paper program that allows us to have a maximum of $2.250 billion in commercial paper outstanding, with maturities up to 364 days from the date of issuance. At October 27, 2006 and April 28, 2006, outstanding commercial paper totaled $248 million and $190 million, respectively. During the three and six months ended October 27, 2006, the weighted average original maturity of the commercial paper outstanding was approximately 56 and 49 days, respectively, and the weighted average interest rate was 5.3% and 5.2%, respectively.

Lines of Credit

We have existing lines of credit of approximately $2.427 billion with various banks at October 27, 2006. The existing lines of credit include two syndicated credit facilities totaling $1.750 billion with various banks. The two credit facilities consist of a five-year $1.000 billion facility, signed on January 20, 2005, which will expire on January 20, 2010, and a five-year $750 million facility, signed on January 24, 2002, which will expire on January 24, 2007. The $1.000 billion facility provides us with the ability to increase the capacity of the facility by an additional $250 million at any time during the life of the five-year term of the agreement. The credit facilities provide backup funding for the commercial paper program and may also be used for general corporate purposes.

Note 9 Comprehensive Income and Accumulated Other Non-Owner Changes in Equity

In addition to net earnings, comprehensive income includes changes in foreign currency translation adjustments (including the change in current exchange rates, or spot rates, of net investment hedges), unrealized gains and losses on foreign exchange derivative contracts qualifying and designated as cash flow hedges, minimum pension liabilities, and unrealized gains and losses on available-for-sale marketable securities. Comprehensive income for the three months ended October 27, 2006 and October 28, 2005 was $702 million and $833 million, respectively. Comprehensive income for the six months ended October 27, 2006 and October 28, 2005 was $1.328 billion and $1.156 billion, respectively.

Presented below is a summary of activity for each component of *accumulated other non-owner changes in equity* (dollars in millions):

	Cumulative Translation Adjustment	Unrealized Gain (Loss) on Foreign Exchange Derivatives	Minimum Pension Liability	Unrealized Gain (Loss) on Investments	Accumulated Other Non-Owner Changes in Equity
Balance April 28, 2006	$177	$16	$(24)	$(14)	$155
Period Change	12	5		9	26
Balance July 28, 2006	189	21	(24)	(5)	181
Period Change	7	2		12	21
Balance October 27, 2006	$196	$23	$(24)	$7	$202

Translation adjustments are not adjusted for income taxes as substantially all translation adjustments relate to our non-U.S. subsidiaries, which are considered permanent in nature. The tax expense on the unrealized gain on derivatives for the three and six months ended October 27, 2006 was $1 million and $4 million, respectively. The tax expense on the unrealized gain on investments for the three and six months ended October 27, 2006 was $6 million and $11 million, respectively.

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Note 10   Retirement Benefit Plans

The Company sponsors various retirement benefit plans, including defined benefit pension plans (pension benefits), defined contribution savings plans, post-retirement medical plans (post-retirement benefits), and termination indemnity plans, covering substantially all U.S. employees and many employees outside the U.S. The net periodic benefit cost of the pension and post-retirement medical plans include the following components for the three and six months ended October 27, 2006 and October 28, 2005 (dollars in millions):

	U.S. Pension Benefits Three months ended		Non-U.S. Pension Benefits Three months ended		Post-Retirement Benefits Three months ended	
	October 27, 2006	**October 28, 2005**	**October 27, 2006**	**October 28, 2005**	**October 27, 2006**	**October 28, 2005**
Service cost	$16	$13	$7	$6	$3	$3
Interest cost	11	10	3	3	3	2
Expected return on plan assets	(18)	(16)	(3)	(3)	(2)	(2)
Recognized actuarial (gain)/loss	4	3		1		1
Net periodic benefit cost	13	10	7	7	4	4
Curtailment charges						
Total Cost for Period	$13	$10	$7	$7	$4	$4

	U.S. Pension Benefits Six months ended		Non-U.S. Pension Benefits Six months ended		Post-Retirement Benefits Six months ended	
	October 27, 2006	October 28, 2005	October 27, 2006	October 28, 2005	October 27, 2006	October 28, 2005
Service cost	$32	$26	$13	$12	$6	$5
Interest cost	23	19	6	5	6	5
Expected return on plan assets	(37)	(32)	(6)	(5)	(5)	(4)
Recognized actuarial (gain)/loss	7	7	1	2	1	2
Net periodic benefit cost	25	20	14	14	8	8
Curtailment charges		2				1
Total Cost for Period	$25	$22	$14	$14	$8	$9

Note 11 Interest (Income)/Expense

Interest income and interest expense for the three and six month periods ended October 27, 2006 and October 28, 2005 are as follows (dollars in millions):

	Three months ended		Six months ended	
	October 27, 2006	October 28, 2005	October 27, 2006	October 28, 2005
Interest income	$(94)	$(42)	$(187)	$(79)
Interest expense	57	28	111	50
Interest income, net	$(37)	$(14)	$(76)	$(29)

Note 12 Income Taxes

During the three and six months ended October 28, 2005, the Company recorded a $225 million tax benefit associated with favorable agreements reached with the United States Internal Revenue Service (IRS) involving the review of fiscal years 1997 through 2002 domestic income tax returns. The $225 million tax benefit is recorded in *provision for income taxes* on the condensed consolidated statements of earnings for the three and six months ended October 28, 2005. As a result of the agreements reached with the IRS, the Company made approximately $326 million in incremental tax payments during fiscal third quarter 2006.

Note 13 Earnings Per Share

Basic earnings per share is computed based on the weighted average number of common shares outstanding. Diluted earnings per share is computed based on the weighted average number of common shares outstanding increased by the number of additional shares that would have been outstanding had the potentially dilutive common shares been issued and reduced by the number of shares the Company could have repurchased from the proceeds of the potentially dilutive shares. Potentially dilutive shares of common stock include stock options and other stock-based awards granted under stock-based compensation plans and shares committed to be purchased under the ESPP.

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Presented below is a reconciliation between basic and diluted earnings per share (in millions, except per share data):

	Three months ended		Six months ended	
	October 27, 2006	October 28, 2005	October 27, 2006	October 28, 2005
Numerator:				
Net earnings	$681	$817	$1,280	$1,137
Denominator:				
Basic weighted average shares outstanding	1,149.3	1,208.6	1,151.4	1,209.6
Effect of dilutive securities:				
Employee stock options	7.6	11.3	8.2	10.9
Shares issuable upon conversion of Old Debentures		0.7	0.4	0.7
Other	2.5	1.9	1.9	1.2
Diluted weighted average shares outstanding	1,159.4	1,222.5	1,161.9	1,222.4
Basic earnings per share	$0.59	$0.68	$1.11	$0.94
Diluted earnings per share	$0.59	$0.67	$1.10	$0.93

The calculation of weighted average diluted shares outstanding excludes options for approximately 42 million and 40 million common shares for the three and six months ended October 27, 2006, respectively, and 1 million and 2 million common shares for each of the three and six months ended October 28, 2005, as the exercise price of those options was greater than the average market price for the period, resulting in an anti-dilutive effect on diluted earnings per share.

Note 14 Segment and Geographic Information

Segment information:

During fiscal fourth quarter 2006, the Company revised its operating segment reporting related to the Neurological and Diabetes operating segment and the Spinal, Ear, Nose and Throat (ENT) and Navigation operating segment. As a result, the Company now maintains seven operating segments, which are aggregated into one reportable segment the manufacture and sale of device-based medical therapies. The information for the three and six months ended October 28, 2005 has been reclassified to conform to the current presentation of seven operating segments. Each of the Company s operating segments has similar economic characteristics, technology, manufacturing processes, customers, distribution and marketing strategies, regulatory environments, and shared infrastructures. Net sales by operating segment were as follows (dollars in millions):

	Three months ended		Six months ended	
	October 27, 2006	October 28, 2005	October 27, 2006	October 28, 2005

Cardiac Rhythm Disease Management	$