OCCIDENTAL PETROLEUM CORP /DE/
Form 10-Q
August 02, 2017
UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 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 1-9210

_____

OCCIDENTAL PETROLEUM CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	95-4035997
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
5 Greenway Plaza, Suite 110 Houston, Texas (Address of principal executive offices)	77046 (Zip Code)

(713) 215-7000
(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.
þ Yes o No

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

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

Large Accelerated Filer þ Accelerated Filer o Non-Accelerated Filer o
Smaller Reporting Company o Emerging Growth Company o

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. o

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at June 30, 2017
Common stock $.20 par value	764,573,083

OCCIDENTAL PETROLEUM CORPORATION AND SUBSIDIARIES

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements (unaudited)

OCCIDENTAL PETROLEUM CORPORATION AND SUBSIDIARIES
CONSOLIDATED CONDENSED BALANCE SHEETS
JUNE 30, 2017, AND DECEMBER 31, 2016
(Amounts in millions)

	2017	2016
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$2,218	$2,233
Trade receivables, net	3,913	3,989
Inventories	920	866
Assets held for sale	558	—
Other current assets	466	1,340
Total current assets	8,075	8,428
INVESTMENTS IN UNCONSOLIDATED ENTITIES	1,572	1,401
PROPERTY, PLANT AND EQUIPMENT, net of accumulated depreciation, depletion and amortization of $37,330 at June 30, 2017, and $38,956 at December 31, 2016	31,466	32,337
LONG-TERM RECEIVABLES AND OTHER ASSETS, NET	869	943
TOTAL ASSETS	$41,982	$43,109

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

OCCIDENTAL PETROLEUM CORPORATION AND SUBSIDIARIES
CONSOLIDATED CONDENSED BALANCE SHEETS
JUNE 30, 2017, AND DECEMBER 31, 2016
(Amounts in millions except share amounts)

	2017	2016
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Current maturities of long-term debt	$500	$—
Accounts payable	3,825	3,926
Accrued liabilities	2,050	2,436
Liabilities of assets held for sale	16	—
Total current liabilities	6,391	6,362
LONG-TERM DEBT, NET	9,324	9,819
DEFERRED CREDITS AND OTHER LIABILITIES		
Deferred domestic and foreign income taxes	1,059	1,132
Other	4,171	4,299
Total deferred credits and other liabilities	5,230	5,431
STOCKHOLDERS' EQUITY		
Common stock, at par value (892,647,217 shares at June 30, 2017, and 892,214,604 shares at December 31, 2016)	179	178
Treasury stock (128,074,134 shares at June 30, 2017, and 127,977,306 shares at December 31, 2016)	(9,149)	(9,143)
Additional paid-in capital	7,824	7,747
Retained earnings	22,435	22,981
Accumulated other comprehensive loss	(252)	(266)
Total stockholders' equity	21,037	21,497
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$41,982	$43,109

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

OCCIDENTAL PETROLEUM CORPORATION AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2017, AND 2016
(Amounts in millions, except per-share amounts)

	Three months ended June 30		Six months ended June 30	
	2017	2016	2017	2016
REVENUES AND OTHER INCOME				
Net sales	$3,060	$2,531	$6,017	$4,654
Interest, dividends and other income	31	27	52	47
Gain on sale of assets, net	512	—	512	138
	3,603	2,558	6,581	4,839
COSTS AND OTHER DEDUCTIONS				
Cost of sales	1,486	1,244	2,912	2,525
Selling, general and administrative and other operating expenses	352	338	624	610
Taxes other than on income	77	74	145	149
Depreciation, depletion and amortization	989	1,070	1,931	2,172
Asset impairments and related items	—	—	13	78
Exploration expense	8	27	19	36
Interest and debt expense, net	86	88	167	148
	2,998	2,841	5,811	5,718
Income (loss) before income taxes and other items	605	(283)	770	(879)
Benefit (provision) for domestic and foreign income taxes	(285)	96	(363)	299
Income from equity investments	187	51	217	84
Income (loss) from continuing operations	507	(136)	624	(496)
Discontinued operations, net	—	(3)	—	435
NET INCOME (LOSS)	$507	$(139)	$624	$(61)
BASIC EARNINGS PER COMMON SHARE				
Income (loss) from continuing operations	$0.66	$(0.18)	$0.81	$(0.65)
Discontinued operations, net	—	—	—	0.57
BASIC EARNINGS PER COMMON SHARE	$0.66	$(0.18)	$0.81	$(0.08)
DILUTED EARNINGS PER COMMON SHARE				
Income (loss) from continuing operations	$0.66	$(0.18)	$0.81	$(0.65)
Discontinued operations, net	—	—	—	0.57
DILUTED EARNINGS PER COMMON SHARE	$0.66	$(0.18)	$0.81	$(0.08)
DIVIDENDS PER COMMON SHARE	$0.76	$0.75	$1.52	$1.50

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

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OCCIDENTAL PETROLEUM CORPORATION AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME
FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2017, AND 2016
(Amounts in millions)

	Three months ended June 30		Six months ended June 30	
	2017	2016	2017	2016
Net income (loss)	$507	$(139)	$624	$(61)
Other comprehensive income (loss) items:				
Foreign currency translation gains	—	—	1	1
Unrealized gains (losses) on derivatives [(a)]	1	(3)	6	(13)
Pension and postretirement gains (losses) [(b)]	(1)	7	8	12
Reclassification to income of realized (gains) losses on derivatives[(c)]	1	1	(1)	8
Other comprehensive income, net of tax	1	5	14	8
Comprehensive income (loss)	$508	$(134)	$638	$(53)

(a) Net of tax of zero and $1 for the three months ended June 30, 2017 and 2016, respectively, and $(3) and $7 for the six months ended June 30, 2017, and 2016, respectively.

(b) Net of tax of $1 and $(4) for the three months ended June 30, 2017 and 2016, respectively, and $(4) and $(7) for the six months ended June 30, 2017, and 2016, respectively.

(c) Net of tax of zero for the three months ended June 30, 2017 and 2016, respectively, and $1 and $(4) for the six months ended June 30, 2017, and 2016, respectively.

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

OCCIDENTAL PETROLEUM CORPORATION AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
FOR THE SIX MONTHS ENDED JUNE 30, 2017 AND 2016
(Amounts in millions)

	2017	2016
CASH FLOW FROM OPERATING ACTIVITIES		
Net income (loss)	$624	$(61)
Adjustments to reconcile income (loss) to net cash provided by operating activities:		
Discontinued operations, net	—	(435)
Depreciation, depletion and amortization of assets	1,931	2,172
Deferred income tax provision (benefit)	(24)	76
Other noncash charges to income	43	37
Gain on sale of assets, net	(512)	(138)
Asset impairments and related items	13	78
Dry hole expenses	7	28
Changes in operating assets and liabilities, net	(306)	(511)
Other operating, net	729	(304)
Operating cash flow from continuing operations	2,505	942
Operating cash flow from discontinued operations	—	876
Net cash provided by operating activities	2,505	1,818
CASH FLOW FROM INVESTING ACTIVITIES		
Capital expenditures	(1,492)	(1,247)
Change in capital accrual	(35)	(209)
Payments for purchases of assets and businesses	(377)	(34)
Proceeds from sale of assets	609	260
Equity investments and other, net	(67)	(104)
Net cash used by investing activities	(1,362)	(1,334)
CASH FLOW FROM FINANCING ACTIVITIES		
Change in restricted cash	—	1,193
Proceeds from long-term debt, net	—	2,718
Payment of long-term debt, net	—	(2,710)
Proceeds from issuance of common stock	16	29
Purchases of treasury stock	(6)	(15)
Cash dividends paid	(1,168)	(1,149)
Net cash provided (used) by financing activities	(1,158)	66
Increase (decrease) in cash and cash equivalents	(15)	550
Cash and cash equivalents — beginning of period	2,233	3,201
Cash and cash equivalents — end of period	$2,218	$3,751

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

OCCIDENTAL PETROLEUM CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
JUNE 30, 2017

1. General

In these unaudited consolidated condensed financial statements, "Occidental" means Occidental Petroleum Corporation, a Delaware corporation (OPC), or OPC and one or more entities in which it owns a controlling interest (subsidiaries). Occidental has made its disclosures in accordance with United States generally accepted accounting principles (GAAP) as they apply to interim reporting, and condensed or omitted, as permitted by the Securities and Exchange Commission's rules and regulations, certain information and disclosures normally included in consolidated financial statements and the notes. These unaudited consolidated condensed financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto in Occidental's Annual Report on Form 10-K for the year ended December 31, 2016.

In the opinion of Occidental's management, the accompanying unaudited consolidated condensed financial statements contain all adjustments (consisting of normal recurring adjustments) necessary to fairly present Occidental's consolidated financial position as of June 30, 2017, the consolidated statements of operations and comprehensive income for the three and six months ended June 30, 2017, and 2016, and cash flows for the six months ended June 30, 2017 and 2016, as applicable. The income and cash flows for the periods ended June 30, 2017 and 2016 are not necessarily indicative of the income or cash flows to be expected for the full year.

2. Asset Acquisitions, Dispositions and Other

In June 2017, Occidental entered into a sales agreement to sell non-strategic acreage in Andrews and Martin Counties, Texas, for approximately $0.6 billion. The assets and liabilities related to these operations were presented as held for sale at June 30, 2017, and primarily included property, plant and equipment and asset retirement obligations. Concurrently, Occidental entered into a purchase agreement to increase its ownership interests and assume operatorship in CO_2 enhanced oil recovery (EOR) properties located in its Permian EOR business unit for $0.6 billion. These transactions closed in the third quarter of 2017, and are subject to customary price adjustments.
In April 2017, Occidental completed the sale of its South Texas operations for net proceeds of $0.5 billion resulting in pre-tax gain of $0.5 billion. The assets and liabilities related to these operations were presented as held for sale at March 31, 2017, and primarily included property, plant and equipment and asset retirement obligations.

3. Accounting and Disclosure Changes

In March 2017, the Financial Accounting Standards Board (FASB) issued guidance related to presentation of net periodic pension cost and net periodic postretirement benefit cost. The rules become effective for annual periods beginning after December 15, 2017. These rules are not expected to have a material impact to Occidental's financial statements upon adoption.

In 2016, the FASB issued rules clarifying several aspects of the new revenue recognition standard, Topic 606, Revenue from Contracts with Customers, previously issued in May 2014. The guidance is effective for interim and annual reporting periods starting January 1, 2018. Under the new standard, an entity will recognize revenue when it transfers promised goods or services to customers in an amount that reflects what it expects to receive in exchange for the goods and services. The new standard also requires more detailed disclosures related to the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Occidental plans to adopt the standard using the modified retrospective approach and recognize a cumulative effect adjustment to Retained Earnings as of January 1, 2018, the date of adoption, subject to certain additional disclosures. Occidental continues to make

progress on evaluating the accounting implications of the standard and has stratified all revenue streams within each operating segment and has compiled an inventory of all contracts. A representative sample of contracts has been pulled from these significant revenue streams and reviewed in detail against the requirements of the new standard to identify whether such contracts are in scope of the new standard; whether there will be material changes in the timing or amount of revenue recognized; whether processes and controls are in place to evaluate new contracts for revenue recognition and to assemble any additional required disclosures. Occidental has finalized the scoping strategy for review of existing and newly executed contracts and assessed disclosure requirements. Additionally,

Occidental has developed training materials to instruct accounting staff on the new standard and should finalize estimates of potential financial impacts by the end of the third quarter. Based upon work performed through June 30, 2017, Occidental does not currently anticipate a material impact to earnings as a result of adopting the new standard and is continuing to evaluate the impact of this and other provisions of the standard on its accounting policies, internal controls and consolidated financial statements and related disclosures.

In February 2016, the FASB issued rules which require Occidental to recognize most leases, including operating leases, on the balance sheet. The new rules require lessees to recognize a right-of-use asset and lease liability for all leases with lease terms of more than 12 months. The lease liability represents the discounted obligation to make future minimum lease payments and the corresponding right-of-use asset on the balance sheet for most leases. The guidance retains the current accounting for lessors and does not make significant changes to the recognition, measurement and presentation of expenses and cash flows by a lessee. Recognition, measurement and presentation of expenses and cash flows arising from a lease will depend on classification as a finance or operating lease. Occidental is the lessee under various agreements for real estate, equipment, plants and facilities, aircraft, IT hardware and vehicles that are currently accounted for as operating leases, refer to Note 6, Lease Commitments in Occidental’s Annual Report on Form 10-K for the year ended December 31, 2016. As a result, these new rules will increase reported assets and liabilities. Occidental will not early-adopt this standard. Occidental will apply the revised lease rules for our interim and annual reporting periods starting January 1, 2019, using a modified retrospective approach, including several optional practical expedients related to leases commenced before the effective date. Occidental is currently evaluating the effect of these rules on its financial statements, developing training materials for accounting staff and reviewing external software solutions for the identification, documentation and tracking of leases in order to create an adoption plan based on Occidental's population of leases under the revised definition of leases. The quantitative impacts of the new standard are dependent on the leases in force at the time of adoption. As a result, the evaluation of the effect of the new standard will extend over future periods.

4. Supplemental Cash Flow Information

Occidental paid foreign and state income taxes of $375 million and $288 million during the six months ended June 30, 2017, and 2016, respectively. Occidental received federal income tax refunds of $749 million and $302 million in the six months ended June 30, 2017 and 2016, respectively. Interest paid totaled $155 million and $154 million in each of the six months ended June 30, 2017, and 2016, respectively.

5. Inventories

Inventories as of June 30, 2017, and December 31, 2016, consisted of the following (in millions):

	2017	2016
Raw materials	$79	$65
Materials and supplies	453	446
Finished goods	429	395
	961	906
Revaluation to LIFO	(41)	(40)
Total	$920	$866

6. Environmental Liabilities and Expenditures

	October 28, 2005	October 29, 2004	October 28,

	2005	October 29, 2004		

Cost of products sold 25.1% 24.4% 24.7% 23.9% Research & development 10.0 9.7 9.9 9.7 Selling, general & administrative 32.7 32.2 32.7 32.5 IPR&D 6.7 Special charges 3.6 1.8 Other expense, net 1.5 2.6 1.7 2.5 Interest income, net (0.5) (0.3) (0.5) (0.2)

Cost of Products Sold

Cost of products sold as a percentage of net sales increased by 0.7 and 0.8 of a percentage point for the three and six months ended October 28, 2005, respectively, over the same periods in the prior year, to 25.1% and 24.7%, respectively. The increase of 0.7 of a percentage point for the three months ended October 28, 2005 was primarily driven by the unfavorable impact of foreign currency translation and the negative impact of vendor supply issues on our manufacturing expenses within our ERS business. For the six months ended October 28, 2005, the increase of 0.8 of a percentage point was predominately driven by the unfavorable impact of foreign currency translation, impact of expenses associated with the expansion of production facilities, manufacturing supply issues in our ERS business noted above and the negative impact of increased warranty expense.

Research and Development

We are committed to developing technological enhancements and new indications for existing products, and less invasive and new technologies to address unmet medical needs. Furthermore, we expect our development activities to help reduce patient care costs and the length of hospital stays in the future. Consistent with prior periods, we have continued to invest heavily in the future by spending aggressively on research and development efforts, with research and development spending during the three and six months ended October 28, 2005, representing 10.0% and 9.9% of net sales, or $275.4 million and $538.6 million, respectively. For the three and six months ended October 28, 2005, research and development spending increased 18.3% and 16.5%, respectively, in comparison to the same periods in the prior year.

Selling, General and Administrative

Selling, general and administrative expense as a percentage of net sales increased by 0.5 and 0.2 of a percentage point for the three and six months ended October 28, 2005, respectively, to 32.7% in each period. The increase as a percentage of net sales primarily relates to our significant investment in expanding our sales and marketing personnel during the latter half of fiscal year 2005 and early fiscal year 2006, additional investments focused on the launch of various new products and our global enterprise resource planning project. These increases were partially offset by continued cost control measures across all of our businesses. We will continue to reinvest in the business through projects such as our global enterprise resource planning project and clinical studies which support the economic benefits of our therapies.

Special and IPR&D Charges

Special and IPR&D charges taken during the three and six months ended October 28, 2005 and October 29, 2004 were as follows:

	Three months ended		Six months ended	
	October 28, 2005	October 29, 2004	October 28, 2005	October 29, 2004
Special charges	$ (100.0)	$	$ (100.0)	$
IPR&D			(363.8)	
Total special and IPR&D charges, pre-tax	(100.0)		(463.8)	

	Three months ended		Six months ended	
Less tax benefit of special and IPR&D charges	34.4		102.9	
Less tax benefit from the reversal of tax reserves	225.0		225.0	
Total special and IPR&D benefits (charges), after tax	$ 159.4	$	$ (135.9)	$

During the second quarter of fiscal year 2006, we recorded a $225.0 million tax benefit associated with favorable agreements reached with the IRS involving the review of fiscal years 1997 through 2002 domestic income tax returns. In the second quarter of fiscal year 2006, we also recorded a $100.0 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 the second quarter of fiscal year 2006. There were no IPR&D charges during the three months ended October 28, 2005.

During the first quarter of fiscal year 2006, we acquired TNI. At the date of the acquisition, $168.7 million of the purchase price was expensed as IPR&D related to a product being developed for the treatment of obesity by stimulation of the stomach, that had not yet reached technological feasibility and had no future alternative use.

During the first quarter of fiscal year 2006, we acquired substantially all of the spine-related intellectual property and related contracts, rights, and tangible materials owned by Michelson. At the date of acquisition, $175.1 million of the purchase price was expensed as IPR&D related to spinal technology based devices that had not yet reached technological feasibility and which 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.

In the first quarter of fiscal year 2006, we also entered into a royalty bearing, non-exclusive patent cross-licensing agreement with NeuroPace, Inc. On the date of the agreement, $20.0 million was expensed as IPR&D related to the licensed technology since technological feasibility of the project had not yet been reached and it had no future alternative use. This licensed technology is expected to enhance our ability to further develop and expand our therapies for neurological disorders.

There were no special and IPR&D charges during the three and six months ended October 29, 2004.

Other Income/Expense

Other income/expense includes intellectual property amortization expense, royalty income and expense, realized minority investment gains and losses, realized foreign currency transaction and derivative gains and losses, and impairment charges. Net other expense for the three and six months ended October 28, 2005 decreased $22.4 million and $26.0 million, to $40.5 million and $91.5 million, respectively, compared to the same periods in the prior year. The decrease of $22.4 million for the three months ended October 28, 2005 was primarily driven by currency hedges, which contributed approximately $27.4 million of income as compared to $18.2 million of expense in the comparable period. The benefit from currency hedges was partially offset by increased royalty expense from increased sales volume in certain CRM, Spinal and Vascular product lines.

For the six months ended October 28, 2005 the decrease of $26.0 million was predominately driven by currency hedges, which contributed approximately $30.1 million of income during the six months ended October 28, 2005, as compared to $42.3 million of expense in the comparable period of the prior year. The positive impact of the currency hedges was partially offset by a decrease in royalty income due to certain royalties we no longer receive and an increase in royalty expense resulting from increased sales volume in certain CRM, Spinal and Vascular product lines.

Interest Income/Expense

For the three and six months ended October 28, 2005, we generated net interest income of approximately $13.4 million and $28.8 million, respectively, as compared to net interest income of approximately $7.1 million and $11.4 million, respectively, for the same periods in the prior year. The increase in net interest income is a result of increased levels of interest-bearing investments and higher interest rates.

Income Taxes

	Three months ended		Six months ended	
	October 28, 2005	October 29, 2004	October 28, 2005	October 29, 2004
	(dollars in millions)			
Income tax (benefit) provision	$ (51.6)	$ 218.8	$ 119.4	$ 435.2
Effective tax rate	(6.7)%	29.0%	9.5%	29.0%
Impact of special and IPR&D charges	30.7%	%	16.5%	%
Nominal tax rate *(1)*	24.0%	29.0%	26.0%	29.0%

(1) Nominal tax rate is defined as the income tax (benefit) provision as a percentage of taxable income, excluding special and IPR&D charges.

Our effective tax rate for the three and six months ended October 28, 2005 decreased by 35.7 and 19.5 percentage points, respectively, from the same periods of the prior year. The positive effective tax rate of (6.7)% for the three months ended October 28, 2005 reflects the impact of favorable agreements reached with the IRS involving the review of fiscal years 1997 through 2002 domestic income tax returns. As a result of the agreements reached with the IRS, we have reversed $225.0 million in previously established tax reserves in the quarter and based on the ongoing impact of the agreements reached with the IRS as well as the continued growth of operations outside the U.S., we have determined that the appropriate nominal tax rate for the full fiscal year 2006 is 26.0% as compared to the 28.0% rate used in the first quarter of fiscal year 2006. The benefit of changing our nominal tax rate from 28.0% to 26.0%, the $225.0 million reversal of tax reserves, and the tax benefit from the $100.0 million charge for the donation to the Medtronic Foundation are included in the 30.7% impact of special and IPR&D charges noted above. The six month effective tax rate of 9.5% for the six months ended October 28, 2005 was a result of the changes noted above and the additional impact of IPR&D charges recorded in the first quarter of fiscal year 2006.

As a result of the agreements reached with the IRS, we have made approximately $326.0 million in incremental tax payments during the third quarter of fiscal year 2006. These payments will reduce *accrued income taxes* in the third quarter of fiscal year 2006 condensed consolidated balance sheet.

On October 22, 2004, the *American Jobs Creation Act of 2004* (Jobs Creation Act) became law. The Jobs Creation Act allows U.S. corporations a one-time deduction of 85 percent of certain cash dividends received from controlled foreign corporations. In the fourth quarter of fiscal year 2005, we recorded a deferred tax liability of $48.5 million based on our intention to repatriate $933.7 million. We expect to repatriate the funds in the fourth quarter of fiscal year 2006.

Liquidity and Capital Resources

	October 28, 2005	April 29, 2005
	(dollars in millions)	
Working capital	$ 3,219.9	$ 4,041.5
Current ratio*	1.7:1.0	2.2:1.0
Cash, cash equivalents, and short-term investments	$ 4,177.3	$ 3,391.6
Long-term investments in debt securities**	1,142.4	1,324.1
Cash, cash equivalents, and short and long-term investments in debt securities	$ 5,319.7	$ 4,715.7
Short-term borrowings and long-term debt	$ 3,836.3	$ 2,451.8
Net cash position***	$ 1,483.4	$ 2,263.9

* Current ratio is the ratio of current assets to current liabilities.

** Long-term investments include public and private debt securities with a maturity date greater than one year from the end of the period.

*** Net cash position is the sum of cash, cash equivalents, short-term investments and long-term investments in debt securities less short-term borrowings and long-term debt.

The decrease in our working capital and current ratio since April 29, 2005, primarily relates to the reclassification of $1,971.4 million of contingent convertible debentures from *long-term debt* to *short-term borrowings* in the second quarter of fiscal year 2006, as a result of the September 2006 put option date being within one year (see further discussion regarding the terms of the contingent convertible debentures in the Debt and Capital section of this management s discussion and analysis) and a decrease in our net cash position since April 29, 2005, which primarily relates to cash used to fund the $1,310.0 million payment to Michelson, the $100.0 million donation to the Medtronic Foundation, and approximately $230.0 million related to the acquisition of TNI in the six months ended October 28, 2005. The payments were partially funded with proceeds from commercial paper and partially offset by cash generated by operations.

As a result of the agreements reached with the IRS, we have made approximately $326.0 million in incremental tax payments during the third quarter of fiscal year 2006.

At October 28, 2005 and April 29, 2005, approximately $4,641.4 million and $3,627.2 million, respectively, of cash, cash equivalents, short-term investments and long-term investments in debt securities were held by our non-U.S. subsidiaries. These funds are available for use by worldwide operations; however, if these funds were repatriated to the U.S. or used for U.S. operations, the amounts would be subject to U.S. tax (also see discussion of the Jobs Creation Act in the Income Taxes section of this management s discussion and analysis).

We believe our existing cash and investments, as well as our unused lines of credit and commercial paper capacity of $2,445.8 million, if needed, will satisfy our foreseeable working capital requirements for at least the next twelve months. However, we periodically consider various financing alternatives and may, from time to time, seek to take advantage of favorable interest rate environments or other market conditions.

Off-Balance Sheet Arrangements and Long-Term Contractual Obligations

We acquire assets still in development, enter into research and development arrangements and sponsor certain clinical trials that often require milestone and/or royalty payments to a third-party, contingent upon the occurrence of certain future events. Milestone payments may be required contingent upon the successful achievement of an important point in the development life cycle of a product or upon certain pre-designated levels of achievement in clinical trials. In addition, if required by the arrangement, we may have to make royalty payments based on a percentage of sales related to the product under development or in the event that regulatory approval for marketing is obtained. In situations where we have no ability to influence the achievement of the milestone or otherwise avoid the payment, we have included those milestone or minimum royalty payments in the following table. However, the majority of these arrangements give us the discretion to unilaterally make the decision to stop development of a product or cease progress of a clinical trial, which would allow us to avoid making the contingent payments. Although we are unlikely to cease development if a device successfully achieves clinical testing objectives, these payments are not included in the table of contractual obligations because of the contingent nature of these payments and our ability to avoid them if we decided to pursue a different path of development or testing.

In the normal course of business, we periodically enter into agreements that require us to indemnify customers or suppliers for specific risks, such as claims for injury or property damage arising out of our products or the negligence of our personnel or claims alleging that our products infringe third-party patents or other intellectual property. Our maximum exposure under these indemnification provisions cannot be estimated, and we have not accrued any liabilities within our condensed consolidated financial statements or included any indemnification provisions in our commitments table. Historically, we have not experienced significant losses on these types of indemnifications.

We believe our off-balance sheet arrangements do not have a material current or anticipated future effect on our consolidated earnings, financial condition, or cash flows. Presented below is a summary of contractual obligations and other minimum commercial commitments as of October 28, 2005.

		Maturity by Fiscal Year					
Total	**2006**	**2007**	**2008**	**2009**	**2010**	**Thereafter**
			(dollars in millions)			
Contractual obligations related to						

	Maturity by Fiscal Year						
off-balance sheet arrangements							
Foreign currency contracts(1)	$ 1,987.8	$ 1,477.7	$ 510.1	$	$	$	$
Operating leases	190.2	36.4	54.8	39.2	24.8	16.6	18.4
Inventory purchases(2)	498.7	125.6	197.6	60.1	26.8	23.4	65.2
Commitments to fund minority investments/contingent acquisition consideration (3)	529.6	29.0	11.4	20.5	88.7	95.0	285.0
Interest Payments (4)	$ 746.6	$ 35.3	$ 70.6	$ 70.6	$ 70.6	$ 70.6	$ 428.9
Other(5)	171.6	39.6	54.2	28.4	20.3	16.5	12.6
Total	$ 4,124.5	$ 1,743.6	$ 898.7	$ 218.8	$ 231.2	$ 222.1	$ 810.1
Contractual obligations reflected in the balance sheet:							
Long-term debt, excluding capital leases(6)	$ 2,971.4	$	$ 1,971.4	$	$	$	$ 1,000.0
Capital leases	1.7	0.3	0.6	0.6	0.2		
Other(7)	39.9	14.4	15.0	3.0	2.5	2.5	2.5
Total	$ 3,013.0	$ 14.7	$ 1,987.0	$ 3.6	$ 2.7	$ 2.5	$ 1,002.5

(1) As these obligations were entered into as hedges, the majority of these obligations will be offset by gains/losses on the related assets, liabilities, and/or transactions being hedged.

(2) We have included inventory purchase commitments, which are legally binding and specify minimum purchase quantities. These purchase commitments do not exceed our projected requirements and are in the normal course of business. These commitments do not include open purchase orders.

(3) Certain commitments related to the funding of minority investments and/or previous acquisitions are contingent upon the achievement of certain product-related milestones and various other favorable operational conditions. While it is not certain if and/or when these payments will be made, the maturity dates included in this table reflect our best estimates.

(4) Interest payments in the table above reflects the interest on our outstanding debt, including the $1,000.0 million of Senior Notes and $1,971.4 million of contingent convertible debentures. The interest rate on each outstanding obligation varies and interest is payable semi-annually. The interest rate is 1.25% on the contingent convertible debentures due 2021, 4.375% on the $400.0 million of Senior Notes due 2010 and 4.750% on the $600.0 million of Senior Notes due 2015.

(5) These obligations include commitments to replace our existing legacy enterprise resource planning systems and certain research and development arrangements.

(6) Long-term debt in the table above includes $1,000.0 million related to our $400.0 million Senior Notes due September 2010 and $600.0 million Senior Notes due September 2015 and the current portion of long-term debt of $1,971.4 million related to our contingent convertible debentures. These debentures were classified in *short-term borrowings* in the condensed consolidated balance sheet as of October 28, 2005 as the holders have the option to require us to repurchase the outstanding securities (referred to as a put option) in September 2006 or at the point our stock price reaches 110% of the conversion price for 20 trading days during a consecutive 30 trading day period.

(7) These obligations include royalty payments and a financing arrangement associated with our fiscal year 2002 Kobayashi Pharmaceutical Co. acquisition.

Debt and Capital

Our capital structure consists of equity and interest-bearing debt. Interest-bearing debt as a percent of total interest-bearing debt and equity was 25.6% and 19.0% at October 28, 2005 and April 29, 2005, respectively.

In October 2003, our Board of Directors authorized the repurchase of up to 30 million shares of our common stock. An additional 40 million shares were authorized for repurchase in October 2005. Shares are repurchased from time to time to support our stock-based compensation programs and to take advantage of favorable market conditions. During the three and six months ended October 28, 2005, we have repurchased approximately 6.0 million and 10.3 million shares at an average price of $55.98 and $54.52, respectively. We have approximately 45.3 million shares remaining under current buyback authorizations approved by the Board of Directors.

In September 2005, we issued two tranches of long-term debt with the aggregate face value of $1,000.0 million. The first tranche consisted of $400.0 million of 4.375 percent Senior Notes due 2010 and the second tranche consisted of $600.0 million of 4.750 percent Senior Notes due 2015. Each tranche was issued at a discount which resulted in an effective rate of 4.433 percent and 4.760 percent 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, beginning March 15, 2006. The Senior Notes are unsecured unsubordinated obligations and rank equally with all other unsecured and unsubordinated indebtedness. The Senior Notes contain other customary covenants and events of default, all of which we remain in compliance with as of October 28, 2005. We used the net proceeds from the sale of the Senior Notes for repayment of a portion of our outstanding commercial paper.

Pursuant to the agreements governing the Senior Notes, we have agreed to file a registration statement with the Securities and Exchange Commission (SEC) within 90 days following the issuance date and to have the registration statement declared effective no later than 180 days after the issuance date. The registered notes will be substantially identical to each originally issued series of Senior Notes. Although we intend to file the registration statement within the previously described time period, we cannot assure that it will become effective within the required timeframe. We have agreed to pay an increased interest rate to holders of the Senior Notes if such condition is not met. Following a default caused by the lack of an effective registration statement by such date, the interest rate on the Senior Notes will accrue at an increased rate per annum of 0.25% of aggregate principal amount for the first 90-day period following the default. If after 90 days the registration statement is still not effective, the interest rate on the Senior Notes will accrue at an increased rate per annum of 0.50% of aggregate principal amount until the exchange offer is completed.

In September 2001, we completed a $2,012.5 million private placement of 1.25 percent 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. The conversion price of the Old Debentures will be adjusted based on the occurrence of specified events, including a stock split, stock dividend, or cash dividend exceeding 15% of our market capitalization.

In September 2002 and 2004, as a result of certain holders of the Old Debentures exercising their put options, we repurchased $38.7 million, or 1.9%, and $0.6 million, or 0.03%, respectively, of the Old Debentures for cash. We may be required to repurchase the remaining securities at the option of the holders in September 2006, 2008, 2011 or 2016. For put options exercised by the holders, the purchase price is equal to the principal amount of the Old Debentures plus any accrued and unpaid interest on the Old Debentures to the repurchase date. If the repurchase option is exercised, we may elect to repurchase the Old Debentures with cash, our common stock, or some combination thereof. We may elect to redeem the Old Debentures for cash at any time after September 2006.

On January 24, 2005, we completed an exchange offer whereby holders of approximately 97.7% of the total principal amount of the Old Debentures exchanged their existing securities for an equal principal amount of 1.25 percent Contingent Convertible Debentures, Series B due 2021 (New Debentures), and an exchange fee of $2.50 per $1,000 principal amount. The terms of the New Debentures are consistent with the terms of the Old Debentures noted above, except that: (i) upon conversion, we will pay holders cash equal to the lesser of the principal amount of the New Debentures or their conversion value, and shares of our common stock to the extent the conversion value exceeds the principal amount; and (ii) the New Debentures require us to pay only cash (in lieu of shares of our common stock or a combination of cash and shares of our common stock) when we repurchase the New Debentures at the option of the holder or in connection with a change of control. The exchange fee paid to the holders of the New Debentures was capitalized and will be amortized over the twenty month period ending in September 2006.

Following the completion of the exchange offer, we repurchased approximately $1.8 million of the Old Debentures for cash. As of October 28, 2005, approximately $43.2 million aggregate principal amount of Old Debentures and $1,928.2 million aggregate principal amount of New

Debentures remain outstanding.

Twelve months prior to the put options becoming exercisable, the remaining balance of the Old and New Debentures will be classified as *short-term borrowings* in the consolidated balance sheets. At each balance sheet date without a put option within the subsequent four quarters, the remaining balance will be classified as *long-term debt* in the consolidated balance sheets. As of October 28, 2005, we reclassified $1,971.4 million of these debentures to *short-term borrowings* due to the put option becoming exercisable in September 2006.

We maintain a $2,250.0 million commercial paper program. This program allows us to have a maximum of $2,250.0 million in commercial paper outstanding, with maturities up to 364 days from the date of issuance. At October 28, 2005 and April 29, 2005, outstanding commercial paper totaled $583.8 million and $249.9 million, respectively. During the three and six months ended October 28, 2005, the weighted average annual original maturity of the commercial paper outstanding was approximately 28 days and 29 days, respectively, and the weighted average annual interest rate was 3.6% and 3.3%, respectively.

In connection with the issuance of the contingent convertible debentures, Senior Notes, and commercial paper, Standard and Poor s Rating Group and Moody s Investors Service issued us strong long-term debt ratings of AA- and A1, respectively, and strong short-term debt ratings of A-1+ and P-1, respectively. These ratings remain unchanged from the same periods in the prior year.

We have existing lines of credit of approximately $2,795.9 million with various banks, at October 28, 2005. The existing lines of credit include two syndicated credit facilities totaling $1,750.0 million with various banks. The two credit facilities consist of a five-year $1,000.0 million facility, which we entered into on January 20, 2005, and which will expire on January 20, 2010, and a five-year $750.0 million facility, which we entered into on January 24, 2002, and which will expire on January 24, 2007. The five-year $1,000.0 million facility replaced the 364-day $500.0 million facility we previously maintained and which expired on January 24, 2005. This $1,000.0 million facility provides us with the ability to increase the capacity of the facility by an additional $250.0 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.

Interest rates on these borrowings are determined by a pricing matrix, based on our long-term debt ratings assigned by Standard and Poor s Ratings Group and Moody s Investors Service. Facility fees are payable on the credit facilities and determined in the same manner as the interest rates. Under terms of the agreements, our consolidated tangible net worth must at all times be greater than or equal to $1,040.4 million, increased by an amount equal to 100% of the net cash proceeds from any equity offering occurring after January 24, 2002. Our consolidated tangible net worth, defined as consolidated assets less goodwill, intangible assets (other than patents, trademarks, licenses, copyrights and other intellectual property, and prepaid assets), and consolidated liabilities at October 28, 2005 and April 29, 2005 was approximately $6,683.4 million and $6,029.3 million, respectively. The agreements also contain other customary covenants and events of default, all of which we remain in compliance with as of October 28, 2005.

Operations Outside of the United States

The following chart illustrates U.S. net sales versus net sales outside the U.S. for the three and six month periods ended October 28, 2005 and October 29, 2004:

For the three and six months ended October 28, 2005, consolidated net sales in the U.S. grew faster than consolidated net sales outside the U.S. primarily as a result of CRM sales increases. For the three months ended October 28, 2005, CRM sales increased approximately 21% in the U.S. while sales of our CRM products outside the U.S. grew 10% and for the six months ended October 28, 2005 CRM sales increased by approximately 19% in the U.S. compared to 12% growth outside the U.S. The growth in CRM, for both the three and six months ended October 28, 2005, was driven by the strong demand for defibrillation systems in the U.S.

Net sales outside the U.S. are accompanied by certain financial risks, such as collection of receivables, which typically have longer payment terms. Outstanding receivables from customers outside the U.S. totaled $1,079.6 million at October 28, 2005, or 43.3%, of total outstanding accounts receivable, and $1,090.4 million at April 29, 2005, or 44.2%, of total outstanding accounts receivable. Operations outside the U.S.

could be negatively impacted by changes in political, labor or economic conditions, changes in regulatory requirements or potentially adverse foreign tax consequences, among other factors.

Additionally, markets outside the U.S. are commonly funded by government-sponsored health care systems. These governments frequently impose reimbursement limits to control government spending and to ensure local health care consumers can obtain medical products and services at a low cost. Decisions made by these government agencies to further limit or eliminate reimbursement for our products could have a material adverse affect on net earnings.

Cautionary Factors That May Affect Future Results

Certain statements contained in this Quarterly Report on Form 10-Q and other written and oral statements made from time to time by us do not relate strictly to historical or current facts. As such, they are considered forward-looking statements which provide current expectations or forecasts of future events. Our forward-looking statements generally relate to our growth strategies, financial results, product development, regulatory approvals, competitive strengths, the scope of our intellectual property rights, mergers and acquisitions, market acceptance of our products, and sales efforts. Such statements can be identified by the use of terminology such as anticipate, believe, could, estimate, expect, forecast, intend, may, plan, possible, project, should, will and similar words or expressions. One must carefully consider forward-lo statements and understand that such statements involve a variety of risks and uncertainties, known and unknown, and may be affected by inaccurate assumptions, including, among others, those discussed in the section entitled Risks Related to Our Business in this Report on Form 10-Q. Consequently, no forward-looking statement can be guaranteed and actual results may vary materially.

We undertake no obligation to update any forward-looking statement, but investors are advised to consult any further disclosures by us on this subject in our filings with the Securities and Exchange Commission, especially on Forms 10-K, 10-Q, and 8-K (if any), in which we discuss in more detail various important factors that could cause actual results to differ from expected or historical results. We intend to take advantage of the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995 regarding our forward-looking statements, and are including this sentence for the express purpose of enabling us to use the protections of the safe harbor with respect to all forward-looking statements. It is not possible to foresee or identify all such factors. As such, investors should not consider any list of such factors to be an exhaustive statement of all risks, uncertainties or potentially inaccurate assumptions.

Risks Related to Our Business

Our business is affected by many factors that may cause our results in the future to differ, possibly materially, from our current expectations or forecasts. Other factors that may affect our future results are also discussed in our most recent Annual Report on Form 10-K.

The medical device industry is highly competitive and we may be unable to compete effectively in the industry.

We compete in both the therapeutic and diagnostic medical markets in more than 120 countries throughout the world. These markets are characterized by rapid change resulting from technological advances and scientific discoveries. In the product lines in which we compete, we face a mixture of competitors ranging from large manufacturers with multiple business lines to small manufacturers that offer a limited selection of products. Development by other companies of new or improved products, processes or technologies may make our products or proposed products less competitive. In addition, we face competition from providers of alternative medical therapies such as pharmaceutical companies. Competitive factors include:

- product reliability,
- product performance,
- product technology,
- product quality,
- breadth of product lines,
- product services,
- customer support,
- price, and

reimbursement approval from healthcare insurance providers.

Major shifts in industry market share have occurred in connection with product problems, physician advisories and safety alerts, reflecting the importance of product quality in the medical device industry. In the current environment of managed care, consolidation among healthcare providers, increased competition and declining reimbursement rates, we have been increasingly required to compete on the basis of price. In order to continue to compete effectively, we must continue to create, invest in or acquire advanced technology, incorporate this technology into our proprietary products, obtain regulatory approvals in a timely manner and manufacture and successfully market these products. Given these factors, there can be no assurance that we will be able to continue our level of success in the industry.

Reduction or interruption in supply and an inability to develop alternative sources for such supply may adversely affect our operations.

We manufacture most of our products at 22 manufacturing facilities located throughout the world. We purchase many of the components and raw materials used in manufacturing these products from numerous suppliers in various countries. For reasons of quality assurance, sole source availability, or cost effectiveness, certain components and raw materials are available only from a sole supplier. We work closely with our suppliers to assure continuity of supply while maintaining high quality and reliability. Due to the FDA s stringent regulations and requirements regarding the manufacture of our products, we may not be able to quickly establish additional or replacement sources for certain components or materials. Generally, we have been able to obtain adequate supplies of such raw materials and components. However, the reduction or interruption in supply, and an inability to develop alternative sources for such supply, could adversely affect our operations.

We are subject to many laws and governmental regulations, and any adverse regulatory action may materially adversely affect our financial condition and business operations.

Our medical devices are subject to regulation by numerous government agencies, including the FDA and comparable foreign agencies. To varying degrees, each of these agencies requires us to comply with laws and regulations governing the development, testing, manufacturing, labeling, marketing and distribution of our medical devices. Obtaining marketing clearance from the FDA for our new products or enhancements or modifications to existing products may:

take a significant amount of time,

require the expenditure of substantial resources,

involve stringent clinical and pre-clinical testing,

involve modifications, repairs or replacements of our products, and

result in limitations on the proposed uses of the products.

Both before and after a product is commercially released, we have ongoing responsibilities under FDA regulations. If the FDA were to conclude that we are not in compliance with applicable laws or regulations, or that any of our medical devices are ineffective or pose an unreasonable health risk, the FDA could ban such medical devices, detain or seize adulterated or misbranded medical devices, order a recall, repair, replacement, or refund of such devices, and require us to notify health professionals and others that the devices present unreasonable risks of substantial harm to the public health. The FDA may also impose operating restrictions, enjoin and restrain certain violations of applicable law pertaining to medical devices, and assess civil or criminal penalties against our officers, employees, or us. The FDA may also recommend prosecution to the Department of Justice. Any adverse regulatory action, depending on its magnitude, may have a material adverse effect on us.

Foreign governmental regulations have become increasingly stringent, and we may be subject to more rigorous regulation by foreign governmental authorities in the future. Penalties for a company s noncompliance with foreign governmental regulation could be severe, including revocation or suspension of a company s business license and criminal sanctions. We cannot predict whether any domestic or foreign governmental law or regulation imposed in the future will have a material adverse effect on us.

We are also subject to various environmental laws and regulations both within and outside the United States. Like other medical device companies, our operations involve the use of substances regulated under environmental laws, primarily manufacturing and sterilization processes. We cannot guarantee that compliance with environmental protection laws will not have a material impact on our consolidated earnings, financial condition, or cash flows.

Failure to comply with regulations relating to reimbursement and healthcare items and services may subject us to penalties and adversely impact our reputation and business operations.

The delivery of our devices is subject to regulation by the United States Department of Health and Human Services and comparable state and foreign agencies responsible for reimbursement and regulation of healthcare items and services. United States laws and regulations are imposed primarily in connection with the Medicare and Medicaid programs, as well as the government s interest in regulating the quality and cost of healthcare. Foreign governments also impose regulations in connection with their healthcare reimbursement programs and the delivery of healthcare items and services. The United States federal healthcare laws apply when we submit a claim on behalf of a federal healthcare program beneficiary, or when a customer submits a claim for an item or service that is reimbursed under Medicare, Medicaid or other federally-funded healthcare programs. The principal federal laws include those that prohibit the filing of false or improper claims for federal payment, those that prohibit unlawful inducements for the referral of business reimbursable under federally-funded healthcare programs, known as the anti-kickback laws, and those that prohibit healthcare service providers seeking reimbursement for providing certain services to a patient who was referred by a physician that has certain types of direct or indirect financial relationships with the service provider, known as the Stark law.

The laws applicable to us are subject to evolving interpretations. If a governmental authority were to conclude that we are not in compliance with applicable laws and regulations, we and our officers and employees, could be subject to severe criminal and civil penalties, including, for example, exclusion from participation as a supplier of product to beneficiaries covered by Medicare or Medicaid.

We are substantially dependent on patent and proprietary rights and costs associated with patent litigation may have a material adverse impact on our financial condition and results of operations.

We operate in an industry characterized by extensive patent litigation. Patent litigation can result in significant damage awards and injunctions that could prevent the manufacture and sale of affected products or result in significant royalty payments in order to continue selling the products. At any given time, we are generally involved as both a plaintiff and a defendant in a number of patent infringement actions, the outcomes of which may not be known for prolonged periods of time. While it is not possible to predict the outcome of patent litigation incident to our business, we believe the costs associated with any litigation could generally have a material adverse impact on our consolidated earnings, financial condition, or cash flows.

We rely on a combination of patents, trade secrets and nondisclosure agreements to protect our proprietary intellectual property, and will continue to do so. There can be no assurance that these patents, trade secrets and nondisclosure agreements will protect our intellectual property, but we will defend against such threats to our intellectual property to the fullest extent. There can also be no assurance that pending patent applications owned by us will result in patents issuing to us, that patents issued to or licensed by us in the past or in the future will not be challenged or circumvented by competitors or that such patents will be found to be valid or sufficiently broad to protect our technology or to provide us with any competitive advantage. Third parties could also obtain patents that may require us to negotiate licenses to conduct our business, but there can be no assurance that the required licenses would be available on reasonable terms or at all. We will also rely on confidentiality agreements with certain employees, consultants and other parties to protect, in part, trade secrets and other proprietary technology. There can be no assurance that these agreements will not be breached, that we will have adequate remedies for any breach, that others will not independently develop substantially equivalent proprietary information or that third parties will not otherwise gain access to our trade secrets or proprietary knowledge. We will defend against such breaches to the fullest extent.

Product liability claims could have a material adverse impact on us.

Our business exposes us to potential product liability risks which are inherent in the design, manufacture and marketing of medical devices. In addition, many of the medical devices manufactured and sold by us are designed to be implanted in the human body for long periods of time. Component failures, manufacturing flaws, design defects or inadequate disclosure of product-related risks or product-related information with respect to these or other products manufactured or sold by us could result in an unsafe condition or injury to, or death of, the patient. The occurrence of such a problem could result in product liability claims or a recall of, or safety alert relating to, one or more of our products which could ultimately result, in certain cases, in the removal from the body of such products and claims regarding costs associated therewith. We have

elected to self-insure with respect to product liability risks. Product liability claims or product recalls in the future, regardless of their ultimate outcome, could have a material adverse effect on our business and reputation and on our ability to attract and retain customers for our products.

Our self-insurance program may not be adequate to cover future losses.

At the beginning of fiscal year 2003, we elected to transition most of our insurable risks to a program of self-insurance, with the exception of director and officer liability insurance, which was transitioned in fiscal year 2004. This decision was made based on current conditions in the insurance marketplace that have led to increasingly higher levels of self-insurance retentions, increasing number of coverage limitations and dramatically higher insurance premium rates. We will continue to monitor the insurance marketplace to evaluate the value to us of obtaining insurance coverage in the future. Based on historical loss trends, we believe that our self-insurance program accruals will be adequate to cover future losses. Historical trends, however, may not be indicative of future losses. These losses could have a material adverse impact on our consolidated earnings, financial condition or cash flows.

Quality problems with our processes, products and services could harm our reputation for producing high quality products and erode our competitive advantage.

Quality is extremely important to us and our customers due to the serious and costly consequences of product failure. Our quality certifications are critical to the marketing success of our products and services. If we fail to meet these standards our reputation could be damaged, we could lose customers and our revenue could decline. Aside from specific customer standards, our success depends generally on our ability to manufacture to exact tolerances precision engineered components, subassemblies and finished devices from multiple materials. If our components fail to meet these standards or fail to adapt to evolving standards, our reputation as a manufacturer of high quality components could be harmed, our competitive advantage could be damaged, and we could lose customers and market share.

If we experience decreasing prices for our products and services and we are unable to reduce our expenses, our results of operations will suffer.

We may experience decreasing prices for the products and services we offer due to pricing pressure experienced by our customers from managed care organizations and other third-party payors; increased market power of our customers as the medical device industry consolidates; and increased competition among medical engineering and manufacturing services providers. If the prices for our products and services decrease and we are unable to reduce our expenses, our results of operations will be adversely affected.

Our international operations are subject to a variety of risks that could adversely affect those operations and thus our profitability and operating results.

Our operations in countries outside the United States, which accounted for 31% of our net sales for the quarter ended October 28, 2005, are accompanied by certain financial and other risks. We intend to continue to pursue growth opportunities in sales internationally, which could expose us to greater risks associated with international sales and operations. Our international operations are, and will continue to be, subject to a number of risk and potential costs, including:

changes in foreign medical reimbursement programs and policies,

unexpected changes in foreign regulatory requirements,

different local product preferences and product requirements,

longer-term receivables than are typical in the United States,

fluctuations in foreign currency exchange rates,

less protection of intellectual property in some countries outside of the United States,

trade protection measures and import and export licensing requirements,

work force instability,

political and economic instability, and

complex tax and cash management issues.

Consolidation in the healthcare industry could have an adverse effect on our revenues and results of operations.

Many healthcare industry companies, including medical device companies, are consolidating to create new companies with greater market power. As the healthcare industry consolidates, competition to provide products and services to industry participants will become more intense. These industry participants may try to use their market power to negotiate price concessions or reductions for medical devices that incorporate components produced by us. If we are forced to reduce our prices because of consolidation in the healthcare industry, our revenues would decrease and our consolidated earnings, financial condition or cash flows would suffer.

Healthcare policy reforms may have a material adverse effect on us.

Healthcare costs have significantly risen over the past decade. There have been and may continue to be proposals by legislators, regulators and third-party payors to keep these costs down. Certain reform proposals and other policy changes, if passed, could impose limitations on the prices we will be able to charge for our products, or the amounts of reimbursement available for our products from governmental agencies or third-party payors. These limitations could have a material adverse effect on our financial position and results of operations.

Our business is indirectly subject to healthcare industry cost containment measures that could result in reduced sales of medical devices containing our components.

Most of our customers and the healthcare providers to whom our customers supply medical devices to, rely on third-party payors, including government programs and private health insurance plans, to reimburse some or all of the cost of the procedures in which medical devices that incorporate components manufactured or assembled by us are used. The continuing efforts of government, insurance companies and other payors of healthcare costs to contain or reduce those costs could lead to patients being unable to obtain approval for payment from these third-party payors. If that were to occur, sales of finished medical devices that include our components may decline significantly, and our customers may reduce or eliminate purchases of our components. The cost containment measures that healthcare providers are instituting, both in the United States and internationally, could harm our ability to operate profitably. For example, managed care organizations have successfully negotiated volume discounts for pharmaceuticals. While this type of discount pricing does not currently exist for medical devices, if managed care or other organizations were able to affect discount pricing for devices, it may result in lower prices to our customers from their customers and, in turn, reduce the amounts we can charge our customers for our design and manufacturing services.

Our research and development efforts rely upon investments and alliances and there is no assurance that any previous or future investments or alliances will be successful.

Our strategy to provide a broad range of therapies to restore patients to fuller, healthier lives requires a wide variety of technologies, products and capabilities. The rapid pace of technological development in the medical industry and the specialized expertise required in different areas of medicine make it difficult for one company alone to develop a broad portfolio of technological solutions. In addition to internally generated growth through our research and development efforts, historically we have relied, and expect to continue to rely, upon investments and alliances to provide access to new technologies both in areas served by our existing businesses as well as in new areas.

We expect to make future investments where we believe that we can stimulate the development of, or acquire, new technologies and products to further our strategic objectives and strengthen our existing businesses. Investments and alliances in and with medical technology companies are inherently risky and no assurance can be given that any of our previous or future investments or alliances will be successful or will not materially adversely affect our consolidated earnings, financial condition, or cash flows.

The success of many of our products depends upon strong relationships with physicians.

If we fail to maintain our working relationships with physicians, many of our products may not be developed and marketed in line with the needs and expectations of the professionals who use and support our products, which could cause a decline in profitability. The research, development, marketing and sales of many of our new and improved products is dependent upon our maintaining working relationships with physicians. We rely on these professionals to provide us with considerable knowledge and experience regarding our products and the marketing of our products. The physicians assist us as researchers, marketing consultants, product consultants, inventors and as public speakers. If we are unable to maintain our strong relationships with these professionals, and continue to receive their advice and input, the development and marketing of our products could suffer, which could have a material effect on our consolidated earnings, financial condition or cash flows.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Due to the global nature of our operations, we are subject to the exposures that arise from foreign exchange rate fluctuations. We manage these exposures using operational and economic hedges as well as derivative financial instruments. The primary currencies hedged are the Euro and the Japanese Yen.

Our objective in managing exposure to foreign currency fluctuations is to minimize earnings and cash flow volatility associated with foreign exchange rate changes. We enter into various contracts, principally forward contracts that change in value as foreign exchange rates change, to protect the value of existing foreign currency assets, liabilities, net investments, and probable commitments. The gains and losses on these contracts offset changes in the value of the related exposures. It is our policy to enter into foreign currency hedging transactions only to the extent true exposures exist; we do not enter into foreign currency transactions for speculative purposes.

We had foreign exchange derivative contracts outstanding in notional amounts of $1,987.8 million and $2,894.0 million at October 28, 2005 and April 29, 2005, respectively. The fair value of these contracts at October 28, 2005 was $64.0 million more than the original contract value. A sensitivity analysis of changes in the fair value of all foreign exchange derivative contracts at October 28, 2005 indicates that, if the U.S. dollar uniformly strengthened/weakened by 10% against all currencies, the fair value of these contracts would increase/decrease by $198.8 million, respectively. Any gains and losses on the fair value of derivative contracts would be largely offset by gains and losses on the underlying transactions. These offsetting gains and losses are not reflected in the above analysis.

We are also exposed to interest rate changes affecting principally our investments in interest rate sensitive instruments. A sensitivity analysis of the impact on our interest rate sensitive financial instruments of a hypothetical 10% change in short-term interest rates compared to interest rates at October 28, 2005 indicates that the fair value of these instruments would change by $10.6 million.

We have entered into an agreement that expires in fiscal year 2006, to sell, at our discretion, specific pools of trade receivables in Japan. During the three and six months ended October 28, 2005 we did not sell any of our trade receivables to financial institutions in Japan. During the three and six months ended October 29, 2004 we sold $39.4 million $93.4 million, respectively, of our trade receivables to financial institutions in Japan. Additionally, we entered into agreements to sell specific pools of receivables in Italy in the amount of $20.5 million during the first quarter of fiscal year 2006. There were no specific pools of receivables sold in Italy during the three and six months ended October 29, 2004 nor the three months ended October 28, 2005. The discount cost related to the Japan and Italy sales was insignificant and recorded in *interest income, net* in the condensed consolidated statements of earnings.

In the third quarter of fiscal year 2004, we began lending certain fixed income securities to enhance our investment income. These lending activities are collateralized at an average rate of 102%, with the collateral determined based on the underlying securities and creditworthiness of the borrowers. The value of the securities on loan at October 28, 2005 and April 29, 2005 was $430.5 million and $361.3 million, respectively.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures and changes in the Company s internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934 (the Exchange Act)) as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this quarterly report, our disclosure controls and procedures are adequately designed to ensure that information required to be disclosed by us in the reports we file or submit under

the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in applicable rules and forms.

Changes in internal control

We are in the process of implementing a new enterprise resource planning (ERP) system using a multi-phased approach. We do not believe that these changes will have an adverse effect on our internal control over financial reporting. Japan (an individually significant entity) implemented the new ERP system during the quarter ended July 29, 2005. The internal controls over Japan s financial reporting were updated to reflect the system changes, and were successfully tested in the quarter ended October 28, 2005. There have been no other changes in our internal control over financial reporting during the period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. We implemented the next phase of the ERP system in our European geographies beginning in our third quarter of fiscal year 2006.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

A discussion of the Company s policies with respect to legal proceedings is discussed in the management s discussion and analysis and our legal proceedings and other loss contingencies are described in Note 16 of the condensed consolidated financial statements. The description of our legal proceedings in Note 16 of the condensed consolidated financial statements to this filing is incorporated herein by reference.

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

Issuer Purchases of Equity Securities

The following table provides information about the shares repurchased by Medtronic during the second quarter of fiscal year 2006:

Fiscal Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as a Part of Publicly Announced Program	Maximum Number of Shares that May Yet Be Purchased Under the Program (1)
07/30/05 - 08/26/05	1,466,600	$ 56.26	1,466,600	9,786,645
08/27/05 - 09/30/05	3,982,100	56.01	3,982,100	5,804,545
10/01/05 - 10/28/05	545,500	54.99	545,500	45,259,045
Total	5,994,200	$ 55.98	5,994,200	45,259,045

(1) In October 2003, our Board of Directors authorized the repurchase of up to 30 million shares of our common stock. An additional 40 million shares were authorized for repurchase in October 2005.

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

At the Company s 2005 Annual Meeting of Shareholders held on August 25, 2005, the shareholders voted on the following:

(a) A proposal to elect four Class I Directors of the Company to serve for three-year terms ending in 2008, as follows:

Director	Votes For	Votes Against
Shirley A. Jackson, Ph.D.	1,000,211,345	48,574,783
Denise M. O Leary	992,258,795	59,527,332
Jean-Pierre Rosso	1,004,033,934	47,752,194
Jack W. Schuler	705,273,023	346,513,105

		Voted For	Voted Against	Abstain	Broker Non-Votes
(b)	To ratify the appointment of PricewaterhouseCoopers LLP as Medtronic s independent registered public accounting firm for fiscal year 2006.	1,034,079,034	10,345,183	7,361,009	N/A
(c)	To approve the Medtronic, Inc. 2005 Employees Stock Purchase Plan.	841,611,034	21,767,310	8,319,989	N/A
(d)	To approve the Medtronic, Inc. 1998 Outside Director Stock Compensation Plan (as amended and restated).	771,058,933	88,369,636	12,264,477	N/A

Item 5. Other Information

As discussed in Part II, Item 4, Submission of Matters to a Vote of Security Holders, on August 25, 2005, the shareholders of Medtronic, Inc. approved the Medtronic, Inc. 1998 Outside Director Stock Compensation Plan (as amended and restated). The descriptions of the terms and conditions of the Medtronic, Inc. 1998 Outside Director Stock Compensation Plan (as amended and restated) are included in the Medtronic, Inc. s Definitive Proxy Statement for its 2005 Annual Meeting of Shareholders and is incorporated herein by reference. The Medtronic, Inc. 1998 Outside Director Stock Compensation Plan (as amended and restated) has been filed as Appendix B to Medtronic, Inc. s Proxy Statement for its 2005 Annual Meeting of Stockholders and is incorporated herein by reference as an exhibit to this report.

Item 6. Exhibits

(a) Exhibits

10.1 Medtronic, Inc. Capital Accumulation Deferral Program, as restated generally effective January 1, 2005 (Incorporated by reference to Exhibit 4.1 in Medtronic s Form S-8 filed with the Commission on November 21, 2005).

10.2 Medtronic, Inc. Supplemental Executive Retirement Plan (as restated October 19, 2005 generally effective May 1, 2005).

10.3 Medtronic, Inc. 1998 Outside Director Stock Compensation Plan (as amended and restated) (Incorporated by reference to Medtronic s Definitive Proxy Statement dated July 21, 2005).

12.1 Computation of Ratio of Earnings to Fixed Charges.

31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

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

Medtronic, Inc.
(Registrant)

Date: December 6, 2005

/s/ Arthur D. Collins, Jr.

Arthur D. Collins, Jr.
Chairman of the Board and
Chief Executive Officer

Date: December 6, 2005

/s/ Gary L. Ellis

Gary L. Ellis
Senior Vice President and
Chief Financial Officer