UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)
[X] Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended March 31, 2006 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 000-49804

Kyphon Inc.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or organization)

77-0366069
(I.R.S. Employer Identification No.)

1221 Crossman Avenue, Sunnyvale, California, 94089
(Address of principal executive offices, including zip code)

(408) 548-6500
(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 requirements for the past 90 days.
YES [X] NO [ ]

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 [ ] Non-accelerated filer [ ]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
YES [ ] NO [X]

Class	Shares Outstanding at April 26, 2006
Common Stock, $0.001 par value	44,221,090

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PART I: FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

KYPHON INC.
CONDENSED CONSOLIDATED INCOME STATEMENTS
(in thousands, except per share amounts)
(unaudited)

	Three Months Ended March 31,	
	2006	**2005**
Net sales	$ 91,428	$ 66,234
Cost of goods sold (1)	10,965	7,925
Gross profit	80,463	58,309
Operating expenses:		
Research and development (1)	8,589	5,460
Sales and marketing (1)	45,386	34,985
General and administrative (1)	13,568	7,698
Total operating expenses	67,543	48,143
Income from operations	12,920	10,166
Interest income and other, net	2,123	525
Income before income taxes	15,043	10,691
Provision for income taxes	6,550	4,270
Net income	$ 8,493	$ 6,421
Net income per share:		
Basic	$ 0.19	$ 0.15
Diluted	$ 0.19	$ 0.15
Weighted-average shares outstanding:		
Basic	44,032	41,843
Diluted	45,882	44,231
(1) Includes employee stock-based compensation charges under FAS 123(R) for the current period and under APB 25 for the prior period as follows:		
Cost of goods sold	$ 164	$ 39
Research and development	958	212
Sales and marketing	2,603	291
General and administrative	2,691	40
	$ 6,416	$ 582

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

KYPHON INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except per share amounts, unaudited)

	March 31, 2006	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 92,084	$ 76,149
Investments	125,138	118,324
Accounts receivable, net	55,535	55,480
Inventories	9,934	9,265
Prepaid expenses and other current assets	20,306	16,387
Total current assets	302,997	275,605
Property and equipment, net	20,166	15,977
Goodwill and other intangible assets, net	15,204	15,377
Other assets	9,629	9,673
Total assets	$ 347,996	$ 316,632
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 10,551	$ 9,308
Accrued liabilities	54,143	49,793
Total current liabilities	64,694	59,101
Deferred rent and other	5,324	4,051
Contingent purchase price	3,556	3,424
Total liabilities	73,574	66,576
Commitments and contingencies (Note 7)		
Stockholders' equity:		
Common stock, $0.001 par value per share	44	44
Additional paid-in capital	246,386	231,312
Treasury stock, at cost	(201)	(201)
Deferred stock-based compensation, net	--	(116)
Accumulated other comprehensive income	855	172
Retained earnings	27,338	18,845
Total stockholders' equity	274,422	250,056
Total liabilities and stockholders' equity	$ 347,996	$ 316,632

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

KYPHON INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands, unaudited)

	Three Months Ended March 31,	
	2006	**2005**
Cash flows from operating activities:		
Net income	$ 8,493	$ 6,421
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for accounts receivable allowances	264	83
Provision for excess and obsolete inventories	175	54
Depreciation and amortization	1,399	1,031
Loss on disposal of property and equipment	117	37
Tax benefits related to stock-based compensation plans	303	4,327
Excess tax benefit related to stock-based compensation plans	(889)	--
Stock-based compensation	6,614	721
Changes in operating assets and liabilities:		
Accounts receivable	84	(1,604)
Inventories	(523)	277
Prepaid expenses and other current assets	(1,808)	1,162
Other assets	62	(274)
Accounts payable	1,203	2,291
Accrued liabilities	4,060	(1,558)
Deferred rent and other	1,455	223
Net cash provided by operating activities	21,009	13,191
Cash flows from investing activities:		
Acquisition of property and equipment	(5,337)	(3,082)
Maturities and sales of investments	22,325	8,750
Purchase of investments	(29,317)	(8,041)
Net cash used in investing activities	(12,329)	(2,373)
Cash flows from financing activities:		
Proceeds from issuance of common stock	2,982	2,456
Proceeds from exercise of stock options	3,193	2,381
Excess tax benefit related to stock-based compensation plans	889	--
Net cash provided by financing activities	7,064	4,837
Effect of foreign exchange rate changes on cash and cash equivalents	191	(232)
Net increase in cash and cash equivalents	15,935	15,423
Cash and cash equivalents at beginning of period	76,149	87,236
Cash and cash equivalents at end of period	$ 92,084	$ 102,659

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

KYPHON INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

NOTE 1--Organization, Basis of Presentation, and Significant Accounting Policies:

Organization

Kyphon Inc. ("Kyphon" or the "Company") is a medical device company focused on the design, manufacture and marketing of instruments used in minimally invasive surgical therapies for the treatment and restoration of spinal anatomy. The Company is currently commercializing surgical tools that use its proprietary balloon technologies for the repair of spinal fractures. The Company markets its products through sales representatives in the United States, and through a combination of sales representatives, distributors and agents in its international markets. The Company is headquartered in Sunnyvale, California, and has subsidiaries in many of the major countries in Europe, as well as in Canada, Japan and Australia.

Basis of Presentation

The accompanying unaudited, condensed, consolidated financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America for interim financial information and pursuant to the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities and Exchange Commission ("SEC"). Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. The results for the three-month period ended March 31, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006, or for any future period. These condensed consolidated financial statements and notes should be read in conjunction with the consolidated financial statements included in the Company's Form 10-K for the fiscal year ended December 31, 2005, which was filed with the SEC on March 3, 2006.

Significant Accounting Policies

The Company's significant accounting policies are disclosed in the Company's Form 10-K for the year ended December 31, 2005. Except as noted below (see Note 2), the Company's significant accounting policies have not changed as of March 31, 2006.

NOTE 2--Stock-Based Compensation:

Employee Stock Purchase Plan

The Company has an Employee Stock Purchase Plan ("ESPP"), under which eligible employees are permitted to purchase common stock at a discount through payroll deductions. The ESPP contains consecutive, overlapping twenty-four month offering periods. Each offering period includes four six-month purchase periods. The price of the common stock purchased shall be the lower of 85% of the fair market value of the common stock at the beginning of an offering period or at the end of a purchase period. The Company issued approximately 119,000 shares of common stock during the three months ended March 31, 2006. As of March 31, 2006, approximately 850,000 shares of common stock remained reserved for future issuance under the ESPP.

Stock Plans

The Company reserved shares of common stock for issuance under the 1996 Stock Incentive Plan (the "1996 Plan"). Under the 1996 Plan, the Board of Directors was authorized to issue incentive stock options to employees and nonqualified stock options to consultants or employees of the Company. The 1996 Plan is inactive, and no shares have been granted under the 1996 Plan since 2002. Upon adoption of the 2002 Stock Plan, all shares previously available for grant under the 1996 Plan were transferred to the 2002 Stock Plan. Any cancellations thereafter from the 1996 Plan are automatically added back to the 2002 Plan.

In April 2002, the Board of Directors adopted the 2002 Stock Plan. The 2002 Stock Plan, which will terminate no later than 2012, provides for the granting of incentive stock options to employees and nonqualified stock options and

stock purchase rights to employees, directors and consultants.

In April 2002, the Board of Directors adopted the 2002 Director Option Plan. The 2002 Director Option Plan, which will terminate no later than 2012, provides for the granting of nonqualified stock options to non-employee directors.

For the 2002 Director Option Plan and the 2002 Stock Plan, the Board of Directors has the authority to determine to whom options will be granted, the number of shares, the term and exercise price (which cannot be less than the estimated fair market value at date of grant for incentive stock options or 85% of the estimated fair market value for nonqualified stock options). If an employee owns stock representing more than 10% of the outstanding shares, the exercise price of any incentive stock option shall be at least 110% of estimated fair market value, as determined by the Board of Directors. The options are exercisable at times and increments as specified by the Board of Directors, and generally expire ten years from date of grant.

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards ("SFAS") No. 123(R), "Share-Based Payment", which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options and employee stock purchases based on estimated fair values. Accordingly, stock-based compensation cost is measured at grant date, based on the fair value of the award, and is recognized as expense over the employee requisite service period. Employee stock-based compensation expense recognized under SFAS No. 123(R) for the three months ended March 31, 2006 was $6,416,000. The Company previously used the intrinsic value method in accounting for its employee stock options, and presented disclosure of pro forma information as if the Company had accounted for stock-based compensation using the fair value method. The Company elected to adopt the modified prospective application method as provided by SFAS No. 123(R). Accordingly, previously reported amounts have not been restated. During the three months ended March 31, 2005, the Company recognized employee stock-based compensation expense of $582,000 under APB No. 25 related to stock options previously issued with exercise prices below the deemed fair market value of the Company's stock at the date of grant. Upon the adoption of SFAS No. 123(R) on January 1, 2006, the Company recorded a cumulative effect adjustment to eliminate the remaining deferred stock-based compensation relating to these equity awards. The deferred stock-based compensation balance of approximately $116,000 as of December 31, 2005 was eliminated against additional paid-in capital upon adoption. The Company did not record a cumulative effect adjustment to record estimated forfeitures for these stock-based awards upon the adoption of SFAS No. 123(R) as it was not significant.

Prior to the adoption of SFAS No. 123(R)

Prior to the adoption of SFAS No. 123(R), the Company provided a reconciliation of net income and net income per share to pro forma net income and pro forma net income per share had compensation cost for the Company's stock option grants to employees and employee stock purchases been determined based on the fair value of each option on the date of grant as follows (in thousands, except per share amounts):

	Three Months Ended March 31, 2005
Net income, as reported	$ 6,421
Add: Stock-based employee compensation expense included in reported net income, net of related taxes	349
Deduct: Total stock-based employee compensation expense, determined under fair value based method for all awards, net of related taxes	(3,104)
Pro forma net income	$ 3,666
Net income per share	
Basic:	
As reported	$ 0.15
Pro forma	$ 0.09
Diluted:	
As reported	$ 0.15
Pro forma	$ 0.08

Valuation and Expense Information under SFAS No. 123(R)

The Company estimates the value of employee stock options on the date of grant using a lattice-binomial model. The lattice-binomial model used by the Company to value employee stock options on the date of grant considers a range of assumptions related to volatility, risk-free interest rate and employee exercise behavior. Expected volatilities are based on a combination of implied market volatilities, historical volatility of the Company's stock price and other factors. The risk-free rate is derived from the U.S. Treasury zero-coupon yield curve in effect at the time of grant over the contractual term of the option. The lattice-binomial model also incorporates exercise and forfeiture assumptions based on an analysis of historical data. The expected life of the stock option grants is derived from the output of the lattice-binomial model and represents the period of time that options granted are expected to be outstanding.

The Company recognized stock-based compensation expense related to employee options and employee stock purchases as follows (in thousands):

	Three Months Ended March 31, 2006
Stock-based compensation by type of award:	
Employee stock options	$ 5,854
Employee stock purchase plan	772
Amount capitalized as inventory	(210)
Total stock-based compensation expense	$ 6,416

As of March 31, 2006, the Company had an unrecorded deferred stock-based compensation balance related to stock options of approximately $38,141,000 after estimated forfeitures, which will be recognized over an estimated weighted-average remaining requisite service period of 2.6 years. During the three months ended March 31, 2006, the Company granted 353,000 stock options with an estimated total grant-date fair value of approximately $3,986,000 after estimated forfeitures.

Valuation Assumptions

The weighted-average assumptions used are as follows:

	Three Months Ended March 31,	
	2006	2005
Stock option plan:		
Risk-free interest rate	4.65%	3.75%
Expected volatility	44%	60%
Expected life (in years)	4.42	4.00
Dividend yield	--	--
Fair value per option granted	$13.50	$12.11
Stock purchase plan:		
Risk-free interest rate	4.59%	3.13%
Expected volatility	38%	60%
Expected life (in years)	1.23	1.27
Dividend yield	--	--
Fair value per share purchased	$13.42	$11.21

Activities under the 2002 Director Option Plan, the 2002 Stock Plan and the 1996 Plan, the ("Plans") for the three months ended March 31, 2006 are as follows:

		Options Outstanding	
	Shares Available for Grant	Number of Shares	Weighted Average Exercise Price
Balances, January 1, 2006	2,574,358	7,078,412	$ 21.78
Options granted	(353,000)	353,000	38.78
Options exercised	--	(261,991)	12.19
Options cancelled	104,596	(104,596)	26.69
Balances, March 31, 2006	2,325,954	7,064,825	$ 22.91

The options outstanding and exercisable at March 31, 2006 by exercise price ranges are as follows:

	Options Outstanding				Options Exercisable		
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Aggregate Intrinsic Value (in thousands)	Options Exercisable	Weighted Average Exercise Price	Aggregate Intrinsic Value (in thousands)
$0.05 - $3.00	657,128	4.71	$ 1.18	$ 23,670	656,971	$ 1.18	$ 23,664
$6.95 - $9.98	375,462	6.84	8.70	10,701	165,969	8.60	4,747
$10.50- $15.40	1,130,827	6.72	13.48	26,823	853,303	13.30	20,394
$19.40 - $27.66	3,146,471	8.27	24.04	41,408	1,132,859	23.77	15,214
$27.90 - $37.11	282,674	9.23	33.15	1,145	36,326	31.32	214
$37.30 - $45.34	1,472,263	9.44	39.07	--	163,474	38.28	--
	7,064,825	7.90	$ 22.91	$ 103,747	3,008,902	$ 15.91	$ 64,233

The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on the Company's closing stock price of $37.20 per share as of March 31, 2006. The total number of in-the-money options exercisable as of March 31, 2006 was 2,845,000. As of December 31, 2005, there were 2,739,000 outstanding options exercisable, and the weighted-average exercise price was $14.40 per share.

The total intrinsic value of options exercised during the three months ended March 31, 2006 was approximately $6,781,000. The total cash received from employees as a result of employee stock option exercises during the three months ended March 31, 2006 was approximately $3,193,000. In connection with these employee stock option exercises, the tax benefits realized by the Company for the three months ended March 31, 2006 was approximately $2,116,000. As of March 31, 2006, as a result of the adoption of SFAS No. 123(R), the Company recorded a $1,888,000 deferred tax asset for the book expenses associated with nonqualified stock options.

The Company settles employee stock option exercises with newly issued common shares.

Non-Employee Stock-Based Compensation

The Company accounts for equity instruments issued to non-employees at their fair value on the measurement date. The measurement of stock-based compensation is subject to periodic adjustment as the underlying equity instruments vest. Stock-based compensation expense related to stock options granted to non-employees is recognized as the stock options are earned. The options generally vest ratably over four years. The values attributable to these options have been amortized over the service period on a graded vesting method, and the vested portion of these options is remeasured at each vesting date. The Company believes that the fair value of the stock options is more reliably measurable than the fair value of the services received. The Company recognized stock-based compensation expense related to non-employee options as follows (in thousands):

	Three Months Ended March 31,	
	2006	2005
Research and development	$ 40	$ 27
Sales and marketing	157	86
General and administrative	--	25
	$ 197	$ 138

NOTE 3--Net Income Per Share:

Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding for the period. Diluted net income per share is computed by giving effect to all potentially dilutive common stock, including options. The dilutive effect of outstanding options is reflected in diluted net income per share by application of the treasury stock method, which includes consideration of stock-based compensation. For the three months ended March 31, 2006 and 2005, 1,491,000 and 804,000 options outstanding, respectively, were not included in the computation of diluted net income per share for the Company because the effect would have been antidilutive.

The following table sets forth the computation of basic and diluted net income per share (in thousands, except per share amounts):

	Three Months Ended March 31,	
	2006	**2005**
Net income (1)	$ 8,493	$ 6,421
Basic weighted-average shares outstanding	44,032	41,843
Dilutive effect of:		
Options to purchase common stock	1,850	2,388
Diluted weighted-average shares outstanding	45,882	44,231
Net income per share:	$ 0.19	$ 0.15
Basic (1)		
Diluted (1)	$ 0.19	$ 0.15

[(1)] Net income for the three months ended March 31, 2006 includes $4,339,000 of stock-based compensation expense, net of taxes. The effect of recording stock-based compensation expense on basic and diluted net income per share was $0.10 and $0.09 per share, respectively.

NOTE 4--Comprehensive Income:

The changes in the components of other comprehensive income for the periods presented are as follows (in thousands):

	Three Months Ended March 31,	
	2006	**2005**
Net income	$ 8,493	$ 6,421
Changes in unrealized gains (losses) on available-for-sale investments, net of taxes	--	(17)
Translation adjustments	683	(958)
Total comprehensive income	$ 9,176	$ 5,446

The components of other comprehensive income are as follows (in thousands):

	March 31, 2006	**December 31, 2005**
Unrealized losses on available-for-sale investments, net of taxes	$ (137)	$ (137)
Translation adjustments	992	309
	$ 855	$ 172

NOTE 5--Inventories:

Inventories consisted of the following (in thousands):

	March 31, 2006	**December 31, 2005**
Raw materials	$ 4,073	$ 4,331
Work-in-process	2,467	1,656
Finished goods	3,394	3,278
	$ 9,934	$ 9,265

NOTE 6--Goodwill and Intangible Assets:

Changes in the carrying amount of goodwill during the three months ended March 31, 2006 are as follows (in thousands):

Goodwill at January 1, 2006	$ 4,310
Foreign currency translation	108
Total goodwill at March 31, 2006	$ 4,418

The components of the Company’s intangible assets are as follows (in thousands):

	March 31, 2006				
	Gross Carrying Amount	Foreign Currency Translation	Accumulated Amortization	Net	Amortization Period
Developed technology	$ 11,000	$ --	$ (275)	$ 10,725	10 years
Patent	142	16	(97)	61	5 years
Total other intangibles	$ 11,142	$ 16	$ (372)	$ 10,786	

	December 31, 2005				
	Gross Carrying Amount	Foreign Currency Translation	Accumulated Amortization	Net	Amortization Period
Developed technology	$ 11,000	$ --	$ --	$ 11,000	10 years
Patent	142	13	(88)	67	5 years
Total intangibles	$ 11,142	$ 13	$ (88)	$ 11,067	

Amortization expense related to the Company's other intangible assets was approximately $283,000 and $8,000 for the three months ended March 31, 2006 and 2005, respectively. Based on the intangible assets balance at March 31, 2006, the Company expects to recognize amortization expense of approximately $849,000 for the remaining nine months of fiscal 2006, approximately $1,132,000 in 2007, approximately $1,105,000 in 2008, and approximately $1,100,000 for each year from 2009 through 2015.

NOTE 7--Commitments and Contingencies:

In November 2005, Dr. Harvinder Sandhu, a well-respected orthopaedic surgeon with whom the Company has an exclusive consulting relationship, and the Company filed suit in federal district court in Memphis, Tennessee against Medtronic Sofamor Danek ("MSD") and several other related corporate entities seeking compensatory and punitive damages and injunctive relief for breach of contract and related covenants, trade secret theft, fraud and correction of inventorship of several patents and patent applications presently owned by MSD, including U.S. Patent No. 6,676,665. The suit also requests, among other relief, that MSD transfer to Dr. Sandhu ownership of the disputed patent and patent applications. The dispute concerns inventions related to an expandable, mechanical bone tamp for use in treating vertebral compression fractures that Dr. Sandhu invented in the late 1990's and which he confidentially disclosed and discussed with MSD. The complaint alleges that MSD later filed for several patents encompassing and claiming Dr. Sandhu's inventions without naming him as inventor of that technology, and that it also incorporated Dr. Sandhu's inventions into its internal *Equestra* project without his permission. The litigation is in its early stages; trial has been set for April 2007. The Company intends to vigorously prosecute its and Dr. Sandhu's case against MSD.

In April 2006, MSD and several other related corporate entities filed suit against the Company in federal district court in the Northern District of California, alleging that the Company's vertebral bone tamps and/or related products infringe three angioplasty balloon dilatation catheter patents, numbers 4,820,349, 5,759,191 and 6,179,856, and a single claim of patent number 6,096,038, which generally concerns treatment of the disc space. The suit seeks damages based upon the making, using, selling and offering for sale of the Company's products, seeks enhanced damages for alleged willful infringement, and seeks to enjoin the Company's continued activities relating to these products. The Company believes the assertions of infringement are without merit. The suit against the Company also seeks a declaratory judgment that five of the Company's U.S. patents, numbers 4,969,888, 5,108,404, 6,235,043, 6,440,138, and 6,863,672, are invalid and not infringed by an "osteotome," which the Company believes is the *Equestra* product already at issue in the Memphis litigation. The Company also believes the declaratory judgment is baseless. Accordingly, the Company has already asked the federal court in Memphis to enjoin and prevent MSD from proceeding with its declaratory judgment in California. The Company has also filed an amended complaint in Memphis, affirmatively asserting the same five U.S. patents against MSD and accusing MSD of willfully infringing those patents through its development and commercialization of the *Equestra*. Although the Company intends to vigorously defend MSD's California lawsuit, MSD's action against the Company subjects the Company to potential

liability for damages, including treble damages, and could require the Company to cease making, using or selling the affected products, or to obtain a license in order to continue to manufacture, use or sell the affected products. While the Company believes it has multiple meritorious defenses to this action, the Company cannot assure you that it ultimately will prevail on any issue in the litigation or that it will be able to successfully defend MSD's charges, nor can the Company provide assurance that any license required would be made available on commercially acceptable terms, if at all. Failure to successfully defend against MSD's action could harm the Company's business, financial condition and operating results. Due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate outcome of this matter at this time and, therefore, cannot estimate the range of possible loss. No provision for any liability that may result upon the resolution of this matter has been made in the accompanying financial statements.

In addition, the Company is subject to legal proceedings, claims, and litigation arising in the ordinary course of business, including intellectual property litigation. While the outcome of these matters is currently not determinable, the Company does not expect that the ultimate costs to resolve these matters will have a material adverse effect the Company's consolidated financial position, results of operations, or cash flows.

In February 2006, the Company entered into a six year lease agreement for a facility in London, England. The total commitment is approximately $266,000 to be paid over the term of the lease.

NOTE 8--Provision for Income Taxes:

Provision for income taxes was $6,550,000 at an effective tax rate of 43.5% for the three months ended March 31, 2006 as compared to $4,270,000 at an effective tax rate of 40.0% for the same period in 2005. The higher effective tax rate for 2006 is primarily due to the impact of expensing certain non-tax deductible stock-based compensation in accordance with SFAS No. 123(R), and the expiration of research and development credits in 2005. As of March 31, 2006, the Company recorded a $1,888,000 deferred tax asset for the book expenses associated with the nonqualified stock options.

NOTE 9--Recent Accounting Pronouncements:

In November 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 151, "Inventory Costs, an amendment of APB No. 43, Chapter 4." SFAS No. 151 amends APB No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) should be recognized as current period charges. In addition, SFAS No. 151 requires that allocation of fixed production overhead to the cost of conversion be based on the normal capacity of the production facilities. The provisions of SFAS No. 151 are effective for fiscal years beginning after June 15, 2005. Accordingly, the provisions of SFAS No. 151 were effective January 1, 2006 for the Company. The adoption of SFAS No. 151 did not have a material impact on the Company's consolidated financial statements.

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

Introduction

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the federal securities laws. These statements include, but are not limited to, those concerning our intentions, beliefs and expectations regarding our future growth, levels of expenses and operating results; developments in Medicare and third-party payor coverage and reimbursement of our products; the timing and success of our clinical trials and regulatory submissions; our belief that our cash and cash equivalents will be sufficient to satisfy our anticipated cash requirements; our expectations regarding our revenues and customers; our distributors and territorial expansion efforts; our beliefs regarding ongoing legal activities with the government and third parties; and our plans to pursue research, development and commercialization of additional spine products developed internally or arising from acquisitions. These statements are subject to risks and uncertainties that could cause actual results and events to differ materially from those expressed or implied by such forward-looking statements. For a detailed discussion of these risks and uncertainties, see the "Risk Factors" section in Item 1A of this Form 10-Q and in Item 1A of 2005 Form 10-K. We caution the reader not to place undue reliance on these forward-looking statements, which reflect

management's analysis only as of the date of this Form 10-Q. We undertake no obligation to update forward-looking statements to reflect events or circumstances occurring after the date of this Form 10-Q.

Management's discussion and analysis of financial condition and results of operations is organized as follows:

- *Executive summary.* This section provides a general description and history of our business, a brief discussion of our product lines and the opportunities, trends, challenges and risks we focus on in the operation of our business.

- *Results of operations.* This section provides our analysis and outlook for the significant line items on our condensed consolidated income statements.

- *Stock-based compensation.* This section describes the accounting method and financial reporting of our stock options granted to employees and non-employees.

- *Seasonality.* This section describes the effects of seasonality on our business.

- *Liquidity and capital resources.* This section provides an analysis of our liquidity and cash flows, as well as a discussion of our commitments that existed as of March 31, 2006.

- *Recent accounting pronouncements.* This section describes the issuance and effects of recently issued accounting pronouncements.

- *Factors affecting future operating results.* This section discusses the most significant factors that could affect our future financial results. The factors discussed in this section are in addition to factors that may be described in the captions discussed above and elsewhere in this report.

Executive Summary

Company Description. We are a global medical device company specializing in the design, manufacture and marketing of medical devices used to diagnose, treat and restore spinal anatomy using minimally invasive surgical technologies. Our devices are presently used primarily by spine specialists, including orthopaedic surgeons and neurosurgeons, interventional radiologists and interventional neuroradiologists, who repair compression fractures of the spine caused by osteoporosis, trauma, cancer or benign lesions through minimally invasive spine surgeries known as balloon kyphoplasty procedures. Our commercial products consist of our *KyphX* instruments, which are used to treat spinal fractures during balloon kyphoplasty, including our proprietary *KyphX* balloon technology, and our proprietary brands of bone filler materials. Most alternative treatments for these types of spinal fractures are either highly invasive or are only pain management therapies. In the third quarter of 2006, we anticipate full market launch of the Functional Anaesthetic Discography (FAD) product line acquired from the InnoSpine acquition in December 2005.

Our corporate headquarters and United States operations are located in Sunnyvale, California, where we conduct our manufacturing, warehousing, research and development, regulatory and administrative activities. Outside the United States, we operate a sales, clinical, regulatory and administrative facility in Brussels, Belgium, a research and biomaterials manufacturing facility in Rosbach, Germany, a clinical, regulatory and administrative facility in Japan, and we have direct selling operations in many of the major countries in Europe and Canada. In November 2005, we leased a facility which serves as a temporary facility in Neuchâtel, Switzerland for us to conduct administrative and distribution activities for our international business while we build a larger facility in that same location. We anticipate the larger facility should be available in 2007, and are currently evaluating financing options for it. We plan to conduct manufacturing, distribution, administrative and certain research and development activities in this Swiss facility to support the growth of our international business. Our global distribution network consists of a direct sales organization of approximately 450 individuals who market our products in the U.S., Europe and Canada. We also have distributors and sales agents in other countries in which we do not have a direct sales force. In Japan, we are presently focused primarily on procuring the appropriate governmental regulatory clearances and approvals necessary to market and sell our *KyphX* products, and we recently enrolled our sixth patient in our Japanese clinical trial.

Effective January 1, 2006, we adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123(R), "Share-Based Payment", which requires us to measure all employee stock-based compensation awards using a fair value method and record such expense in our consolidated financial statements. Prior to January 1, 2006, we

used the intrinsic value method in accounting for our employee stock options, and presented disclosure of pro forma information as if we had accounted for stock based compensation using the fair value method. We have chosen to implement SFAS No. 123(R) using the modified prospective method. Under this method, periods prior to January 1, 2006 are not restated to reflect stock-based compensation using a fair value method.

Products and Significant Business Trends. Our net sales consist of the sales of our *KyphX* instruments, including our *KyphX* Inflatable Bone Tamps, *KyphX* Inflation Syringe, *KyphX* Bone Access Systems, *KyphX* Bone Filler Device, *KyphX* Curettes, *KyphX* Bone Biopsy Device, *KyphX HV-R* Bone Cement, *KyphX* Mixer and our CE-Marked *KyphOs* calcium phosphate from our acquisition of Sanatis GmbH (Sanatis). In addition, we have commenced a limited initial launch of our FAD technology we recently successfully acquired from InnoSpine, Inc.

During the first quarter of 2006, our business experienced significant growth. Net sales in the first quarter of 2006 increased to $91.4 million, compared to $66.2 million in the first quarter of 2005, representing growth of 38%. We trained over 600 physicians during the first quarter of 2006, primarily in the United States and in Europe. In the U.S., we added 66 new hospitals to our customer base during the first quarter of 2006.

We have moved beyond our original sole focus of spinal deformity correction, through treatment of vertebral compression fractures, to our second business focus, disc repair and regeneration. We have a variety of internal resources dedicated to supporting research and development in this area as well as potential business development opportunities. Our third business focus, cancer therapy aimed at addressing the actual cancerous conditions that affect the spine rather than merely the effects of those cancerous conditions, such as vertebral compression fractures, remains an area of interest for us and we continue to investigate how and when best to enter that initiative. We believe both additional business initiatives provide further opportunity to grow our company in the area of minimally invasive spinal diagnosis and therapies.

Significant Industry Factors. Our industry is impacted by numerous competitive, regulatory and other significant factors. The growth of our business relies on our ability to continue to develop new products and innovative technologies, obtain regulatory clearances and compliance for our products, obtain adequate public and private payor reimbursements for our products, protect the proprietary technology of our products and our manufacturing processes, manufacture our products cost-effectively, and successfully market and distribute our products in a profitable manner. We, and the entire industry, are subject to extensive government regulation, including but not limited to the United States Food and Drug Administration. Failure to comply with all applicable regulatory and legal requirements could adversely affect our business and our financial condition, which could cause our stock price to decline. Additionally, our industry is highly competitive and our success depends on our ability to compete successfully. A detailed discussion of these and other factors is provided in Item 1A “Risk Factors” below.

Results of Operations

Three Months Ended March 31, 2006 and March 31, 2005

The following table sets forth, for the periods indicated, our results of operations expressed as dollar amounts (in thousands) and as percentages of net sales:

	Three Months Ended March 31,			
	2006		2005	
	Amount	% of Net sales	Amount	% of Net sales
U.S. net sales	$ 75,512	83%	$ 57,866	87%
International net sales	15,916	17%	8,368	13%
Net sales	91,428	100%	66,234	100%
Cost of goods sold	10,965	12%	7,925	12%
Gross profit	80,463	88%	58,309	88%
Operating expenses:				
Research and development	8,589	9%	5,460	8%
Sales and marketing	45,386	50%	34,985	53%
General and administrative	13,568	15%	7,698	12%
Total operating expenses	67,543	74%	48,143	73%
Income from operations	12,920	14%	10,166	15%
Interest income and other, net	2,123	2%	525	1%
Income before income taxes	15,043	16%	10,691	16%
Provision for income taxes	6,550	7%	4,270	6%
Net income	$ 8,493	9%	$ 6,421	10%

Net Sales. Net sales increased $25.2 million, or 38%, for the three months ended March 31, 2006 as compared to the same period in 2005. The increases in net sales primarily resulted from an increase in the number of physicians trained in the use of our *KyphX* instruments as well as a 15% increase in the number of procedures performed by trained physicians per month compared to the same period in 2005. During the first quarter of 2006, over 600 physicians were trained in the use of our *KyphX* instruments. Domestic sales increased $17.6 million, or 30% for the three months ended March 31, 2006 as compared to the same period in 2005. International sales increased $7.5 million, or 90% for the three months ended March 31, 2006 as compared to the same period in 2005. International sales also reflected the unfavorable currency impact of $1.4 million in 2006 based on the prior year's same quarter average Euro rates. No customer accounted for more than 10% of total net sales for the three months ended March 31, 2006 and 2005, respectively. As of March 31, 2006, we had trained approximately 5,300 spine specialists in the U.S. and approximately 3,300 clinicians in other parts of the world, primarily in Europe. We believe the total number of potential physicians who may perform balloon kyphoplasty procedures using our products is approximately 11,000 in the U.S. Internationally, the number of physicians who may perform balloon kyphoplasty is not as well-defined, but we believe it to be more than 10,000. We have targeted at least $398 million in net sales for 2006.

Cost of Goods Sold. Cost of goods sold consists of material, labor, subcontract, and overhead costs. Cost of goods sold increased $3.0 million, or 38%, for the three months ended March 31, 2006 as compared to the same period in 2005. The absolute increase in cost of goods sold resulted primarily from increased material, labor, subcontract and overhead costs in relation to the increased sales volume of our products in addition to a $164,000 increase in stock-based compensation expense recognized in accordance with SFAS No. 123(R). Our cost of goods sold and corresponding gross profit percentages can be expected to fluctuate in future periods depending upon changes in our product sales mix and prices, distribution channels and geographies, manufacturing yields, period expenses and levels of production volume. As a percentage of net sales, we expect cost of goods sold to be in the range of 12% to 13% for 2006.

Research and Development. Research and development expenses consist of costs for product research, product development, clinical functions and outside costs related to clinical trials and personnel. Research and development expenses increased $3.1 million, or 57%, in the three months ended March 31, 2006 as compared to the same period in 2005. The increase was attributable to increased personnel costs of $808,000, a $760,000 increase in stock-based compensation expense recognized in accordance with SFAS No. 123(R), increased clinical studies expense of $542,000, increased consulting expenses of $279,000, and increased product testing and development expenditures of $243,000. We expect to continue to make substantial investments in research and development and anticipate that research and development expenses in 2006 will increase in absolute dollars as compared to 2005, excluding the license acquisition charges of $21.0 million relating to Dr. Sandhu and to Dr. Berger in the prior year period, due

largely to the commencement of clinical studies. We anticipate conducting significant additional clinical trial activity both in the United States and abroad to collect further data that may support the use and clinical efficacy of our products. As a percentage of net sales, we anticipate our research and development expenses to be in the range of 10% to 11% for 2006.

Sales and Marketing. Sales and marketing expenses consist of costs for personnel, physician training programs and marketing activities. Sales and marketing expenses increased $10.4 million, or 30%, in the three months ended March 31, 2006 as compared to the same period in 2005. The increase was primarily attributable to a $6.4 million increase in the costs of hiring, training and compensating additional direct selling representatives, $2.4 million stock-based compensation expense recognized in accordance with SFAS No. 123(R), and increased sales and marketing travel expenses of $1.2 million. As we continue to commercialize our *KyphX* instruments on a global basis, we expect to significantly increase our sales and marketing efforts and expenditures in absolute dollars while maintaining our sales and marketing expenses as a percentage of net sales at 47% to 48% for 2006.

General and Administrative. General and administrative expenses consist of costs for personnel, professional service fees, expenses related to legal issues and intellectual property rights, Sarbanes-Oxley compliance and general corporate expenses. General and administrative expenses increased $5.9 million, or 76%, in the three months ended 2006 as compared to the same period in 2005. The increase was primarily attributable to a $2.5 million increase in stock-based compensation expense recognized in accordance with SFAS No. 123(R), increased personnel costs of $1.8 million, increased consulting and outside professional service fees of $1.1 million, increased travel expenses of $394,000 and increased facility expenses of $381,000. The increases were offset partially by decreased litigation costs of $804,000. We expect general and administrative expenses to increase in the future as we add personnel, continue to expand our patent portfolio, incur additional public reporting, governmental compliance and investor-related expenses as a public company, incur increased litigation expenses prosecuting and defending various relevant legal claims, and incur start-up costs for our new facility in Switzerland. Therefore, we anticipate that our general and administrative expenses will increase in absolute dollars as we expand our infrastructure. As a percentage of net sales, we expect that our general and administrative expenses will be approximately 14% to 15% in 2006.

Interest Income and Other, Net. Interest income and other, net, increased $1.6 million, or 304%, in the three months ended March 31, 2006 as compared to the same period in 2005. The increase resulted primarily from an increase in interest income due to higher cash, cash equivalents and investment balances, as well as higher interest rates. Our cash, cash equivalents and investments balances were $217.2 million and $130.3 million as of March 31, 2006 and 2005, respectively.

Provision for Income Taxes. Provision for income taxes was $6.6 million at an effective tax rate of 43.5% for the three months ended March 31, 2006 as compared to $4.3 million at an effective tax rate of 40.0% for the same period in 2005. The higher effective tax rate for 2006 is primarily due to the impact of expensing certain non-tax deductible stock-based compensation in accordance with SFAS No. 123(R), and the expiration of research and development credits in 2005. We recorded a $1.9 million deferred tax asset for the book expenses associated with the nonqualified stock options as of March 31, 2006. We believe that in 2006 our effective tax rate will be approximately 43% of income before taxes, with the actual amount of taxes paid reduced by the utilization of net operating loss and research and development tax credit carryforwards as well as deductions due to stock option activities.

Stock-Based Compensation

Effective January 1, 2006, we adopted the provisions of Statement of Financial Accounting Standards ("SFAS") No. 123(R), "Share-Based Payment", which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options and employee stock purchases based on estimated fair values. Accordingly, stock-based compensation cost is measured at grant date, based on the fair value of the award, and is recognized as expense over the employee requisite service period. Stock-based compensation expense recognized under SFAS No. 123(R) for the three months ended March 31, 2006 was $6,416,000. We previously used the intrinsic value method in accounting for our employee stock options, and presented disclosure of pro forma information as if we had accounted for stock based compensation using the fair value method. During the three months ended March 31, 2005, we recognized stock-based compensation expense of $582,000 related to employee stock options issued prior to our initial public offering with exercise prices below the deemed fair market value of our stock at the date of grant.

We estimate the value of employee stock options on the date of grant using a lattice-binomial model. The

determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to our expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors.

During the three months ended March 31, 2006, we recognized stock-based compensation charges related to our employee stock options and employee stock purchase plan of $5.9 million, and $772,000, respectively. Of that total charge approximately $210,000 of stock-based compensation was capitalized as inventory as of March 31, 2006. As of March 31, 2006, the unrecorded deferred stock-based compensation balance related to employee stock options was $38.1 million after estimated forfeitures and will be recognized over an estimated weighted-average remaining requisite service period of 2.6 years.

In our recent Proxy filing, we proposed that our shareholders approve a new Employee Stock Purchase Plan that, if approved, would take effect on and after the offering period ending February 1, 2007 under the current plan. Details of the proposed ESPP plan are included in that filing.

Stock-based compensation expense for stock options granted to non-employees is recognized as the stock options are earned. The stock-based compensation expense will fluctuate as the fair market value of our common stock fluctuates. In connection with the grant of stock options to non-employees, we recorded stock-based compensation expense of approximately $197,000 and $138,000 for the three months ended March 31, 2006 and 2005, respectively.

Seasonality

Our business is seasonal in nature. Historically, demand for our products has been the highest in the first and second quarters in the U.S. and in the second and fourth quarters in Europe. In the U.S., during the fourth quarter, our net sales generally reflect the reduced number of selling days due to the holiday season. In Europe, we traditionally experience somewhat lower sales volumes in the third quarter months than throughout the rest of the year as a result of the European summer holiday schedule. In addition, the fourth quarter in Europe is typically favorably impacted by certain customers' budget utilization patterns and our distributors' fulfillment of their annual purchase commitments.

Liquidity and Capital Resources

As of March 31, 2006, we had $92.1 million of cash and cash equivalents, $125.1 million of short-term investments, and working capital of $238.3 million. Our cash and cash equivalents and investments increased by $22.7 million during the first quarter of 2006.

Cash Provided by Operating Activities. Our operating cash flow for the three months ended March 31, 2006 was primarily the result of our operational profitability. Net cash provided by operations was $21.0 million, attributable primarily to net income of $8.5 million adjusted for non-cash charges related to stock-based compensation of $6.6 million and depreciation and amortization expenses of $1.4 million. Net cash provided by operations for the three months ended March 31, 2005 was $13.2 million, attributable primarily to net income of $6.4 million adjusted for non-cash charges related to the tax benefits from stock-based compensation plans of $4.3 million and depreciation and amortization expenses of $1.0 million.

The increase in cash provided by operating activities for all periods was adjusted by changes in our working capital. During the three months ended March 31, 2006, accounts receivable decreased by $84,000 as we increased collection efforts; inventories increased by $523,000 in order to meet the increased demand for our products; prepaid expenses and other current assets increased by $1.8 million due to the timing of certain deposits and annual license fee payments; accounts payables increased by $1.2 million due to our increased operating expenses; accrued liabilities increased by $4.1 million due to increased payroll and income tax accruals; deferred rent and other increased $1.5 million due to additional facilities being leased. During the three months ended March 31, 2005, accounts receivable increased $1.6 million due to increased net sales; inventories decreased $277,000 due to improved inventory management; prepaid expenses and other current assets decreased by $1.2 million due to the timing of the prepaid expenses; accounts payables increased $2.3 million due to increased operating expenses; accrued liabilities decreased $1.6 million mainly due to decreased employee stock purchase and income tax accruals; deferred rent and other increased $223,000 due to additional facilities being leased.

In the first quarter of 2006, we adopted SFAS No. 123(R), which requires that the excess benefit of tax deductions over the recognized compensation cost for nonqualified employee stock options be reported as cash flow from financing activities rather than as cash flow from operations.

Cash Used in Investing Activities. Net cash used in investing activities was $12.3 million for the three months ended March 31, 2006 and resulted from the net investment purchases of $7.0 million, and purchases of property and equipment of $5.3 million primarily due to the outfitting of our Sunnyvale facility. Net cash used in investing activities was $2.4 million for the three months ended March 31, 2005 and resulted primarily from the purchase of information systems to improve our infrastructure and operating efficiencies.

Cash Provided by Financing Activities. Net cash provided by financing activities was $7.1 million during the three months ended March 31, 2006 and was attributable primarily to issuance of common stock under the employee stock purchase plan of $3.0 million and proceeds from the exercise of stock options of $3.2 million. Net cash provided by financing activities was $4.8 million during the three months ended March 31, 2005 and was attributable to proceeds from the issuance of common stock under the employee stock purchase plan of $2.5 million and exercise of stock options of $2.4 million.

Contractual Cash Obligations. As of March 31, 2006 we had contractual cash obligations as follows (in thousands):

	Payment Due by Periods						
	Total	Remainder of 2006	2007	2008	2009	2010	After 2010
Operating leases	$ 24,550	$ 2,576	$ 3,455	$ 2,999	$ 2,971	$ 2,996	$ 9,553
Consulting agreement	175	50	100	25	--	--	--
License agreement	15,000	5,000	10,000	--	--	--	--
Purchase commitments with contract manufactures and suppliers	11,182	10,870	312	--	--	--	--
Purchase obligations	9,795	8,839	956	--	--	--	--
Asset retirement obligation	322	--	--	--	--	--	322
Total commitments	$ 61,024	$ 27,335	$ 14,823	$ 3,024	$ 2,971	$ 2,996	$ 9,875

The amounts reflected in the table above for operating leases represent aggregate future minimum lease payments under non-cancellable facility leases. Portions of these payments and a portion of the asset retirement obligations are denominated in foreign currencies and were translated in the tables above based on their respective U.S. dollar exchange rates at March 31, 2006. These future payments are subject to foreign currency exchange rate risk.

We are obligated to make a series of payments totaling up to $15.0 million related to the license acquisition agreement with Dr. Sandhu. The payments of these additional obligations, which shall be paid annually unless accelerated, may be accelerated upon defined events and circumstances or may be forgiven upon the occurrence of a third party event, outside the control of the Company. Based on management judgment, ability and intent, this amount has been classified as a current liability as of March 31, 2006.

On December 30, 2005, we entered into a definitive agreement to acquire InnoSpine, Inc., a privately held company focused on developing and marketing its proprietary technology platform for the diagnosis and potential treatment of axial low back pain due to disc degeneration. The terms of the acquisition called for an initial purchase price of $2.5 million in cash to the shareholders of InnoSpine, plus the possibility of up to an additional $27.5 million in cash or stock, based on achievement of clinical and other milestones as well as royalties on future net sales. This contingent purchase price liability is not included in the table above.

Purchase Commitments with Contract Manufacturers and Suppliers. We purchase components from a variety of suppliers and use contract manufacturers to provide manufacturing services for our products. During the normal course of business, in order to manage manufacturing lead times and to help assure adequate component supply, we enter into agreements with contract manufacturers and suppliers that either allow them to procure inventory based upon criteria as defined by us or that establish the parameters defining our requirements. In certain instances, these

agreements allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to firm orders being placed. Consequently, only a portion of our reported purchase commitments arising from these agreements are firm, noncancelable, and unconditional commitments. The purchase commitments for inventory are expected to be fulfilled within one year.

Purchase Obligations. Purchase obligations represent an estimate of all open purchase orders and contractual obligations in the ordinary course of business, other than commitments with contract manufacturers and suppliers, for which we have not received the goods or services. Although open purchase orders are considered enforceable and legally binding, the terms generally allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to the delivery of goods or performance of services.

Off-Balance Sheet Arrangements. We do not have any off-balance sheet financing as of March 31, 2006. All of our subsidiaries are included in the financial statements, and we do not have relationships with any special purpose entities.

Stock Repurchase. Our Board of Directors approved a stock repurchase program on November 7, 2002, pursuant to which we may purchase up to 2,000,000 shares of our outstanding common stock. The duration of the repurchase program is open-ended. Under the program, we may purchase shares of common stock through open market transactions at prices deemed appropriate by management and the Board of Directors. The purchases will be funded from available working capital. In 2002, we repurchased 30,000 shares pursuant to this repurchase program. We have not repurchased any of our common stock since 2002.

Summary. We believe our current cash, cash equivalents, investments and cash generated from operations will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next 12 months. We anticipate conducting significant additional clinical trial activity both in the United States and abroad to collect further data that may support the use and clinical efficacy of our products. The costs of these trials will be significant. If existing cash, cash equivalents, and cash generated from operations are insufficient to satisfy our liquidity requirements, whether as a result of investment in new markets or businesses through both internal or external business development, expansion of product lines, additional clinical trials, possible increased capital expenditures, or for other reasons related to our business, we may seek to sell additional equity securities or obtain a credit facility. The sale of additional equity or convertible debt securities could result in dilution to our stockholders. If additional funds are raised through the issuance of debt securities, these securities could have rights senior to those associated with our common stock, and could contain covenants that would restrict our operations. And additional financing may not be available in amounts or on terms acceptable to us, or at all. If we are unable to obtain adequate financing when needed, we may have to delay, reduce the scope of, or eliminate certain of our business expansion activities.

Recent Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 151, "Inventory Costs, an amendment of Accounting Principles Board (APB) Opinion No. 43, Chapter 4." SFAS No. 151 amends APB No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) should be recognized as current period charges. In addition, SFAS No. 151 requires that allocation of fixed production overhead to the cost of conversion be based on the normal capacity of the production facilities. The provisions of SFAS No. 151 are effective for fiscal years beginning after June 15, 2005. Accordingly, the provisions of SFAS No. 151 became effective January 1, 2006 for us. The adoption of SFAS No. 151 did not have a material impact on our consolidated financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to interest rate risk at March 31, 2006 is related primarily to our investment portfolio. Our investment portfolio includes fixed rate debt instruments of high quality corporate issuers and asset-backed securities. A change in prevailing interest rates may cause the fair value of our investments to fluctuate. For example, if we hold a security that was issued with a fixed interest rate at the then-prevailing rate and the prevailing rate rises, the fair value of the principal amount of our investment will probably decline. To minimize this risk, investments are generally held to maturity and the weighted average duration of our investments is 12 months or less. Due to the short-term nature of these investments, we believe we have no material exposure to interest rate risk arising from our investments. As of March 31, 2006, the carrying value of these investments approximates fair market value. We do not believe any of

our investments are other than temporarily impaired at March 31, 2006.

We have operated mainly in the United States, and 83% and 87% of our sales were made in U.S. dollars for the three months ended March 31, 2006 and 2005, respectively. The majority of our non-U.S. sales are derived from European Union countries and denominated in the Euro. Monthly income and expense from our European operations are translated using average rates and balance sheets are translated using month-end rates. Differences are recorded within stockholders' equity as a component of accumulated other comprehensive income or to the income statement, as applicable. As our revenues denominated in currencies other than the dollar increase, we have an increased exposure to foreign currency rate risk. Based on our overall exposure for foreign currency at March 31, 2006, a hypothetical 10% change in foreign currency rates would not have a material impact on our net sales and operating expenses. We may elect to mitigate this rate risk, in part or in whole, through the purchase of forward currency contracts.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures. The Chief Executive Officer, Richard W. Mott, and Chief Operating Officer and Chief Financial Officer, Arthur T. Taylor, evaluated the effectiveness of Kyphon's disclosure controls and procedures as of the end of the period covered by this report, and concluded that Kyphon's disclosure controls and procedures were effective to ensure that the information Kyphon is required to disclose in the reports that it files or submits with the Securities and Exchange Commission under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms, and to ensure that the information required to be disclosed by Kyphon in the reports that it files or submits under the Exchange Act is accumulated and communicated to Kyphon's management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in internal control over financial reporting. During the quarter ended March 31, 2006, there were no changes in Kyphon's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, Kyphon's internal control over financial reporting.

PART II: OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In November 2005, Dr. Harvinder Sandhu, a well-respected orthopaedic surgeon with whom Kyphon has an exclusive consulting relationship, and Kyphon filed suit in federal district court in Memphis, Tennessee against Medtronic Sofamor Danek ("MSD") and several other related corporate entities seeking compensatory and punitive damages and injunctive relief for breach of contract and related covenants, trade secret theft, fraud and correction of inventorship of several patents and patent applications presently owned by MSD, including U.S. Patent No. 6,676,665. The suit also requests, among other relief, that MSD transfer to Dr. Sandhu ownership of the disputed patent and patent applications. The dispute concerns inventions related to an expandable, mechanical bone tamp for use in treating vertebral compression fractures that Dr. Sandhu invented in the late 1990's and which he confidentially disclosed and discussed with MSD. The complaint alleges that MSD later filed for several patents encompassing and claiming Dr. Sandhu's inventions without naming him as inventor of that technology, and that it also incorporated Dr. Sandhu's inventions into its internal *Equestra* project without his permission. The litigation is in its early stages; trial has been set for April 2007. We intend to vigorously prosecute our and Dr. Sandhu's case against MSD.

In April 2006, MSD and several other related corporate entities filed suit against us in federal district court in the Northern District of California, alleging that our vertebral bone tamps and/or related products infringe three angioplasty balloon dilatation catheter patents, numbers 4,820,349, 5,759,191 and 6,179,856, and a single claim of patent number 6,096,038, which generally concerns treatment of the disc space. The suit seeks damages based upon the making, using, selling and offering for sale of our products, seeks enhanced damages for alleged willful infringement, and seeks to enjoin our continued activities relating to these products. We believe the assertions of infringement are without merit. The suit against us also seeks a declaratory judgment that five of our U.S. patents, numbers 4,969,888, 5,108,404, 6,235,043, 6,440,138, and 6,863,672, are invalid and not infringed by an "osteotome," which we believe is the *Equestra* product already at issue in the Memphis litigation. We also believe the declaratory judgment is baseless. Accordingly, we have already asked the federal court in Memphis to enjoin and prevent MSD from proceeding with its declaratory judgment in California. We have also filed an amended complaint in Memphis,

affirmatively asserting the same five U.S. patents against MSD and accusing MSD of willfully infringing those patents through its development and commercialization of the *Equestra*. Although we intend to vigorously defend MSD's California lawsuit, MSD's action against us subjects us to potential liability for damages, including treble damages, and could require us to cease making, using or selling the affected products, or to obtain a license in order to continue to manufacture, use or sell the affected products. While we believe we have multiple meritorious defenses to this action, we cannot assure you that we ultimately will prevail on any issue in the litigation or that we will be able to successfully defend MSD's charges, nor can we provide assurance that any license required would be made available on commercially acceptable terms, if at all. Failure to successfully defend against MSD's action could harm our business, financial condition and operating results. Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of this matter at this time and, therefore, cannot estimate the range of possible loss.

In addition, we are subject to legal proceedings, claims, and litigation arising in the ordinary course of business, including intellectual property litigation. While the outcome of these matters is currently not determinable, we do not expect that the ultimate costs to resolve these matters will have a material adverse effect on our consolidated financial position, results of operations, or cash flows.

ITEM 1A. RISK FACTORS

The following are new or modified risk factors that should be read in conjunction with the risk factors disclosed in our 2005 Annual Report on Form 10-K:

We are involved in patent infringement litigation with Medtronic Sofamor Danek and related entities that may harm our competitive position, may be costly to us and may prevent us from selling our products.

In April 2006, MSD and several other related corporate entities filed suit against us in federal district court in the Northern District of California, alleging that our vertebral bone tamps and/or related products infringe three angioplasty balloon dilatation catheter patents, numbers 4,820,349, 5,759,191 and 6,179,856, and a single claim of patent number 6,096,038, which generally concerns treatment of the disc space. The suit seeks damages based upon the making, using, selling and offering for sale of our products, seeks enhanced damages for alleged willful infringement, and seeks to enjoin our continued activities relating to these products. The suit against us also seeks a declaratory judgment that five of our U.S. patents, numbers 4,969,888, 5,108,404, 6,235,043, 6,440,138, and 6,863,672, are invalid and not infringed by an "osteotome," which we believe is the *Equestra* product already at issue in the Memphis litigation. While we believe the assertions of infringement are without merit and the declaratory judgment is baseless, we cannot assure you that the outcome of this litigation will be favorable to us. If we lose the suit against us, it will hurt our competitive position, may be costly to us and may prevent us from selling our products. In addition, if we lose, we may need to obtain a license to the patented technology, which could be expensive, or could require us to license to MSD some of our own technology, which would result in a partial loss of our competitive advantage in the marketplace, each of which could seriously harm our business. If MSD is successful in its patent suit and is unwilling to grant us a license, we may be required to stop selling our products that are found to infringe any the asserted patents unless we can redesign them so they do not infringe, which we may be unable to do. In addition, if we lose, we could be required to pay damages, including treble damages, which could be substantial and harm our financial position.

Defending this suit and prosecuting our related suit against MSD in federal court in Memphis, Tennessee, will be expensive to litigate, the litigation may be protracted and our confidential information may be compromised. Whether or not we are successful in these lawsuits, this litigation could consume substantial amounts of our financial and managerial resources. At any time, MSD may file additional claims against us, or we may file further claims against MSD, which could increase the risk, expense and duration of the litigations. For more information on our litigation with MSD, see "Part II-Item 1: Legal Proceedings."

Public announcements of litigation events may hurt our stock price.

During the course of our lawsuits with MSD and our other legal activities, including the U.S. Attorney's Office (USAO) investigation of our sales and marketing practices, there may be public announcements of various proceedings or developments, including announcements concerning the results of hearings, motions and other issues. If securities analysts or investors perceive such information to be negative, it could have a substantial negative effect

on the trading price of our stock.

We are aware that a complaint, which we believe is a *qui tam* complaint, is being evaluated by a U.S. Attorney's Office in connection with our marketing and sales practices, including those relating to the Medicare reimbursement available to our customer hospitals. If a subpoena or an enforcement or other action ultimately results from this investigation, our business and financial condition could be adversely affected which could cause our stock price to decline.

We have learned that sometime in 2005, the USAO received a complaint that we believe is a *qui tam* complaint that alleges impropriety in our business, including regarding our reimbursement practices. Although no subpoena has been issued to us, the USAO in connection with this complaint is investigating our sales and marketing practices, including those relating to Medicare reimbursement available to our customer hospitals, based on site-of-service, for using Kyphon's products in surgery, and has asked to review some of our documentation that may be relevant to the investigation. We believe we are in substantial compliance with the healthcare laws relevant to our Company. Even though we have not received a subpoena regarding the complaint or its allegations, we continue to voluntarily cooperate with the USAO, to permit the USAO to develop an informed opinion on whether or not to pursue any action in connection with the complaint based in part on the information we provide, although timing on that decision is uncertain. At this time, we do not know whether the outcome of the investigation will have a material adverse impact to our business, and cannot assure you regarding any future path USAO or any related lawsuit may take. If an enforcement or other action results from the ongoing investigation, our business and financial condition could be adversely affected which could cause our stock price to decline.

Recent changes in the required accounting treatment for stock options will have a material negative impact on our financial statements and may affect our stock price.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards SFAS No. 123(R), pursuant to which we must measure all stock-based compensation awards, including grants of employee stock options, using a fair value-based method and record such expense in our consolidated financial statements. We were required to expense employee stock-based compensation awards beginning January 1, 2006. Previously, we disclosed such expenses on a pro forma basis in the notes to our consolidated financial statements, but we did not record a charge for employee stock option expense in the financial statements. As a result of our beginning to comply with SFAS No. 123(R) as of January 1, 2006, our reported earnings decreased and we expect this trend to continue for the foreseeable future, which may affect our stock price. In addition, our reported earnings have increased volatility due to the tax impact and timing of employee stock option exercises, which could further negatively impact our financial statements and cause our stock price to decline.

ITEM 5. OTHER INFORMATION

In accordance with Section 10A(i)(2) of the Securities Exchange Act of 1934, as added by Section 202 of the Sarbanes-Oxley Act of 2002 (the "Act"), we are required to disclose the non-audit services approved by our Audit Committee to be performed by PricewaterhouseCoopers LLP, our independent registered public accounting firm. Non-audit services are defined in the Act as services other than those provided in connection with an audit or a review of the financial statements of a company. The Audit Committee has approved the engagement of PricewaterhouseCoopers LLP for the following non-audit services: (1) various tax matter consultations concerning foreign, U.S. federal and state taxes; and (2) the preparation of federal and state income tax returns.

ITEM 6. EXHIBITS

Number	Description
3.2 (7)	Amended and Restated Certificate of Incorporation of the registrant.
3.4 (7)	Amended and Restated Bylaws of the registrant.
4.1 (1)	Specimen common stock certificate of the registrant.
10.1* (1)	Form of Indemnification Agreement for directors and executive officers.

10.2*	(1)	1996 Stock Option Plan, including form of option agreement.
10.3*	(1)	2002 Stock Plan, including form of option agreement.
10.4*	(1)	2002 Employee Stock Purchase Plan, including form of employee stock purchase plan subscription agreement.
10.5*	(1)	2002 Director Option Plan, including form of option agreement.
10.8	(1)	Lease dated January 27, 2000 for office space located at 1350 Bordeaux Drive, Sunnyvale, CA 94089 and Second Amendment to Lease dated November 29, 2001.
10.8.1	(1)	Third Amendment to Lease dated March 29, 2002 for office space located at 1350 Bordeaux Drive, Sunnyvale, CA 94089.
10.9*	(1)	Employment Agreement between the registrant and Gary L. Grenter dated July 16, 2001.
10.10	(1)	Promissory Note Secured by Deed of Trust between the registrant and Gary L. Grenter dated December 31, 2001.
10.11	(1)	Amended and Restated Stockholder Rights Agreement effective as of December 14, 1999, among the registrant and certain stockholders of the registrant.
10.12*	(2)	Employment Agreement between the registrant and Richard W. Mott dated September 3, 2002.
10.13†	(2)	Sublicense Agreement effective as of August 19, 2002, between the registrant and Bonutti Research, Inc.
10.14	(3)	Stock Purchase Agreement by and between Kyphon and the shareholders of Sanatis GmbH, dated February 15, 2003.
10.15	(4)	Lease dated September 18, 2003 for office spaces located at 1221 Crossman Avenue and 480 Java Drive, Sunnyvale, California.
10.16*	(5)	Form of Severance Agreement entered into by and between Kyphon Inc. and its executive officers.
10.17*	(5)	Severance Agreement, dated January 28, 2005, entered into by and between Kyphon Inc. and Richard W. Mott.
10.18	(6)	First Amendment to Lease Agreement, made as of September 28, 2005, by and between Moffett Office Park Investors LLC, a Delaware limited liability company, and Kyphon Inc.
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		Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(1) Incorporated by reference from our Registration Statement on Form S-1 (Registration No. 333-83678), which was declared effective on May 16, 2002.
(2) Incorporated by reference from our Quarterly Report on Form 10-Q as filed with the Securities Exchange Commission on November 13, 2002.
(3) Incorporated by reference from our Current Report on Form 8-K as filed with the Securities Exchange Commission on March 7, 2003.
(4) Incorporated by reference from our Quarterly Report on Form 10-Q as filed with the Securities Exchange Commission on November 14, 2003.
(5) Incorporated by reference from our Current Report on Form 8-K as filed with the Securities Exchange Commission on February 1, 2005.
(6) Incorporated by reference from our Quarterly Report on Form 10-Q as filed with the Securities Exchange Commission on November 1, 2005.

(7) Incorporated by reference from our Annual Report on Form 10-K as filed with the Securities Exchange Commission on March 3, 2006.

* Management compensatory plan or arrangement required to be filed as an exhibit pursuant to Item 15(c) of Form 10-K.

† Confidential treatment requested on portions of this exhibit. Unredacted versions of this exhibit have been filed separately with the Commission.

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.

Kyphon Inc.

Date: May 10, 2006

By: /s/ Richard W. Mott

Richard W. Mott
President, Chief Executive Officer
and Director (Principal Executive Officer)

Date: May 10, 2006

By: /s/ Arthur T. Taylor

Arthur T. Taylor
Vice President, Chief Operating Officer
and Chief Financial Officer
(Principal Accounting and Financial Officer)

Exhibit 31.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO
SECTION 13(a) OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
AS ADOPTED PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Richard W. Mott certify that:

1. I have reviewed this quarterly report on Form 10-Q of Kyphon Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in the Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the Audit Committee of the registrant's Board of Directors (or persons performing the equivalent functions):

(a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 10, 2006

By: /s/ Richard W. Mott
Richard W. Mott
President, Chief Executive Officer and Director
(Principal Executive Officer)

Exhibit 31.2

CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO
SECTION 13(a) OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
AS ADOPTED PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Arthur T. Taylor certify that:

1. I have reviewed this quarterly report on Form 10-Q of Kyphon Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in the Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the Audit Committee of the registrant's Board of Directors (or persons performing the equivalent functions):

(a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 10, 2006 By: /s/ Arthur T. Taylor

Arthur T. Taylor
Vice President, Chief Operating Officer and Chief Financial Officer
(Principal Accounting and Financial Officer)

Exhibit 32.1

CERTIFICATIONS OF CHIEF EXECUTIVE OFFICER
AND CHIEF FINANCIAL OFFICER
PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

I, Richard W. Mott, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Kyphon Inc. on Form 10-Q for the fiscal quarter ended March 31, 2006 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of Kyphon Inc.

Date: May 10, 2006 By: /s/ Richard W. Mott

Richard W. Mott
President, Chief Executive Officer and Director
(Principal Executive Officer)

I, Arthur T. Taylor, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Kyphon Inc. on Form 10-Q for the fiscal quarter ended March 31, 2006 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of Kyphon Inc.

Date: May 10, 2006 By: /s/ Arthur T. Taylor

Arthur T. Taylor
Vice President, Chief Operating Officer
and Chief Financial Officer
(Principal Accounting and Financial Officer)