BOSTON SCIENTIFIC CORP
Form 10-Q
August 06, 2014

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, 2014

OR

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

Commission File No. 1-11083
BOSTON SCIENTIFIC CORPORATION
(Exact name of registrant as specified in its charter)

DELAWARE	04-2695240
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

300 BOSTON SCIENTIFIC WAY, MARLBOROUGH, MASSACHUSETTS 01752-1234
(Address of principal executive offices) (zip code)
(508) 683-4000
(Registrant’s telephone number, including area code)
ONE BOSTON SCIENTIFIC PLACE, NATICK, MASSACHUSETTS 01760-1537
(Former name, former address and former fiscal year, if changed since last report)

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

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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).Yes þ No o

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

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

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

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

Class	Shares outstanding as of July 31, 2014
Common Stock, $.01 par value	1,325,707,830

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PART I
FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

BOSTON SCIENTIFIC CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

	Three Months Ended June 30,		Six Months Ended June 30,	
in millions, except per share data	2014	2013	2014	2013
Net sales	$1,873	$1,809	$3,647	$3,570
Cost of products sold	563	530	1,100	1,108
Gross profit	1,310	1,279	2,547	2,462
Operating expenses:				
Selling, general and administrative expenses	743	661	1,409	1,292
Research and development expenses	206	223	397	427
Royalty expense	25	47	65	87
Amortization expense	109	101	218	204
Goodwill impairment charges	—	—	—	423
Intangible asset impairment charges	110	53	165	53
Contingent consideration expense (benefit)	(96)	(18)	(118)	(41)
Restructuring charges	15	26	35	36
Litigation-related charges (credits)	267	—	260	130
Gain on divestiture	—	(34)	(12)	(40)
	1,379	1,059	2,419	2,571
Operating income (loss)	(69)	220	128	(109)
Other (expense) income:				
Interest expense	(53)	(65)	(108)	(130)
Other, net	18	(3)	22	(3)
Income (loss) before income taxes	(104)	152	42	(242)
Income tax expense (benefit)	(108)	22	(95)	(18)
Net income (loss)	$4	$130	$137	$(224)
Net income (loss) per common share — basic	$0.00	$0.10	$0.10	$(0.17)
Net income (loss) per common share — assuming dilution	$0.00	$0.10	$0.10	$(0.17)
Weighted-average shares outstanding				
Basic	1,323.2	1,343.5	1,322.4	1,347.7
Assuming dilution	1,345.0	1,358.6	1,347.1	1,347.7

See notes to the unaudited condensed consolidated financial statements.

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BOSTON SCIENTIFIC CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (UNAUDITED)

	Three Months Ended June 30,		Six Months Ended June 30,	
(in millions)	2014	2013	2014	2013
Net income (loss)	$4	$130	$137	$(224)
Other comprehensive income (loss):				
Foreign currency translation adjustment	(2)	(6)	(8)	(3)
Net change in unrealized gains and losses on derivative financial instruments, net of tax	(28)	43	(55)	118
Net change in certain retirement plans	—	—	(1)	—
Total other comprehensive income (loss)	(30)	37	(64)	115
Total comprehensive income (loss)	$(26)	$167	$73	$(109)

See notes to the unaudited condensed consolidated financial statements.

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BOSTON SCIENTIFIC CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

in millions, except share and per share data	As of June 30, 2014 (Unaudited)	December 31, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$357	$217
Trade accounts receivable, net	1,287	1,307
Inventories	949	897
Deferred income taxes	320	288
Prepaid expenses and other current assets	301	302
Total current assets	3,214	3,011
Property, plant and equipment, net	1,534	1,546
Goodwill	5,735	5,693
Other intangible assets, net	5,659	5,950
Other long-term assets	335	371
TOTAL ASSETS	$16,477	$16,571
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Current liabilities:		
Current debt obligations	$3	$3
Accounts payable	241	246
Accrued expenses	1,277	1,348
Other current liabilities	252	227
Total current liabilities	1,773	1,824
Long-term debt	4,252	4,237
Deferred income taxes	1,302	1,402
Other long-term liabilities	2,606	2,569
Commitments and contingencies		
Stockholders’ equity		
Preferred stock, $.01 par value - authorized 50,000,000 shares, none issued and outstanding		
Common stock, $.01 par value - authorized 2,000,000,000 shares and issued 1,571,332,742 shares as of June 30, 2014 and 1,560,302,634 shares as of December 31, 2013	16	16
Treasury stock, at cost - 247,566,270 shares as of June 30, 2014 and 238,006,570 shares as of December 31, 2013	(1,717)	(1,592)
Additional paid-in capital	16,635	16,579
Accumulated deficit	(8,432)	(8,570)
Accumulated other comprehensive income (loss), net of tax	42	106
Total stockholders’ equity	6,544	6,539
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$16,477	$16,571

See notes to the unaudited condensed consolidated financial statements.

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BOSTON SCIENTIFIC CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

in millions	Six Months Ended June 30, 2014	2013
Cash provided by operating activities	$483	$584
Investing activities:		
Purchases of property, plant and equipment	(124)	(104)
Proceeds from sale of property, plant and equipment	—	53
Purchases of privately held securities	(6)	(8)
Purchase of notes receivable	(10)	(3)
Proceeds from sales of publicly traded and privately held equity securities and collections of notes receivable	12	—
Payments for acquisitions of businesses, net of cash acquired	(72)	—
Payments for investments in companies and acquisitions of certain technologies	(1)	(7)
Proceeds from business divestitures, net of costs	12	30
Cash used for investing activities	(189)	(39)
Financing activities:		
Payment of contingent consideration	(15)	(15)
Proceeds from borrowings on credit facilities	650	240
Payments on borrowings from credit facilities	(650)	(240)
Payments for acquisitions of treasury stock	(125)	(200)
Cash used to net share settle employee equity awards	(47)	(25)
Proceeds from issuances of shares of common stock	33	19
Cash used for financing activities	(154)	(221)
Effect of foreign exchange rates on cash	—	(1)
Net increase (decrease) in cash and cash equivalents	140	323
Cash and cash equivalents at beginning of period	217	207
Cash and cash equivalents at end of period	$357	$530
Supplemental Information		
Non-cash operating activities:		
Stock-based compensation expense	$53	$50
Fair value of contingent consideration recorded in purchase accounting	$3	$—

See notes to the unaudited condensed consolidated financial statements.

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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE A – BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of Boston Scientific Corporation have been prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP) and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring adjustments) considered necessary for fair presentation have been included. Operating results for the three and six months ended June 30, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. For further information, refer to the consolidated financial statements and footnotes thereto included in Item 8 of our 2013 Annual Report on Form 10-K.

Additionally, certain prior year cash outflows from net share settling employee equity awards to satisfy their tax withholding requirement have been reclassified from an operating activity to a financing activity within our condensed consolidated statements of cash flows. Amounts reclassified from operating to financing activities on the cash flows were not material. In addition, we have reclassified certain other prior year amounts to conform to the current year presentation. Refer to Note L - Segment Reporting for more information.

Subsequent Events

We evaluate events occurring after the date of our most recent accompanying unaudited condensed consolidated balance sheets for potential recognition or disclosure in our financial statements. We did not identify any material subsequent events requiring adjustment to our accompanying unaudited condensed consolidated financial statements (recognized subsequent events) for the three and six month periods ended June 30, 2014. Those items requiring disclosure (unrecognized subsequent events) in the financial statements have been disclosed accordingly. Refer to Note J - Commitments and Contingencies for more information.

NOTE B – ACQUISITIONS

On May 7, 2014, we completed the acquisition of the remaining fully diluted equity of IoGyn, Inc. (IoGyn). Prior to the acquisition, we held approximately 28 percent minority interest in IoGyn in addition to notes receivable of approximately $8 million. Total consideration was comprised of a net cash payment of $65 million at closing to acquire the remaining 72 percent of IoGyn equity and repay outstanding debt. IoGyn has developed the Symphion™ System, a next generation system for hysteroscopic intrauterine tissue removal including fibroids (myomas) and polyps. In March 2014, IoGyn received U.S. FDA approval for the system, and we expect to launch the system in the United States in the second half of 2014. We will integrate the operations of the IoGyn business with our gynecological surgery business, which is part of our Urology and Women's Health division.

On May 15, 2014, we entered into a definitive agreement to acquire the Interventional Division of Bayer AG, for $415 million in cash at closing. We expect to close this transaction in the second half of 2014, subject to customary closing conditions.

We did not close any material acquisitions during the first half of 2013.

Purchase Price Allocation

We accounted for the acquisition of IoGyn as a business combination and, in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification® (ASC) Topic 805, Business Combinations, we have recorded the assets acquired and liabilities assumed at their respective fair values as of the acquisition date. The components of the aggregate purchase price for the acquisition consummated in 2014 are as follows (in millions):

Cash, net of cash acquired	$65
Fair value of prior interests	31
	$96

We re-measured our previously held investments to their estimated acquisition-date fair value of $31 million and recorded a gain of $19 million in other, net, in the accompanying condensed consolidated statements of operations during the second quarter of 2014. We measured the fair values of the previously held investments based on the liquidation preferences and priority of the equity interests and debt, including accrued interest.

Total consideration for the 2014 acquisition included cash payments of $65 million, net of cash acquired, at closing of the transaction.

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The following summarizes the aggregate purchase price allocation for the 2014 acquisition as of June 30, 2014 (in millions):

Goodwill	$ 39
Amortizable intangible assets	72
Other net assets	(1)
Deferred income taxes	(14)
	$ 96

We allocated a portion of the purchase price to specific intangible asset categories as follows:

	Amount Assigned (in millions)	Weighted Average Amortization Period (in years)	Range of Risk-Adjusted Discount Rates used in Purchase Price Allocation
Amortizable intangible assets:			
Technology-related	$ 71	14	14%
Other intangible assets	1	2	14%
	$ 72		

Our technology-related intangible assets consist of technical processes, intellectual property, and institutional understanding with respect to products and processes that we will leverage in future products or processes and will carry forward from one product generation to the next. We used the income approach to derive the fair value of the technology-related intangible assets, and are amortizing them on a straight-line basis over their assigned estimated useful lives.

We believe that the estimated intangible asset values represent the fair value at the date of acquisition and do not exceed the amount a third party would pay for the assets. These fair value measurements are based on significant unobservable inputs, including management estimates and assumptions and, accordingly, are classified as Level 3 within the fair value hierarchy prescribed by ASC Topic 820, Fair Value Measurements and Disclosures.
We recorded the excess of the aggregate purchase price over the estimated fair values of the identifiable assets acquired as goodwill, which is not deductible for tax purposes. Goodwill was established due primarily to synergies expected to be gained from leveraging our existing operations as well as revenue and cash flow projections associated with future technologies, and has been allocated to our reportable segments based on the relative expected benefit. See Note D - Goodwill and Other Intangible Assets for more information related to goodwill allocated to our reportable segments.

Contingent Consideration
Certain of our acquisitions involve contingent consideration arrangements. Payment of additional consideration is generally contingent on the acquired company reaching certain performance milestones, including attaining specified revenue levels, achieving product development targets and/or obtaining regulatory approvals. In accordance with U.S. GAAP, we recognize a liability equal to the fair value of the contingent payments we expect to make as of the acquisition date. We remeasure this liability each reporting period and record changes in the fair value through a separate line item within our consolidated statements of operations.
We recorded a net benefit related to the change in fair value of our contingent consideration liabilities of $96 million in the second quarter of 2014, $118 million in the first half of 2014, $18 million in the second quarter of 2013, and $41 million during the first half of 2013. We paid contingent consideration of $3 million in the second quarter of 2014, $15 million in the first half of 2014 and $15 million during the second quarter and first half of 2013.

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Changes in the fair value of our contingent consideration liability were as follows (in millions):

Balance as of December 31, 2013	$(501)
Amounts recorded related to new acquisitions	(3)
Other amounts recorded related to prior acquisitions	(1)
Net fair value adjustments	118
Payments made	15
Balance as of June 30, 2014	$(372)

As of June 30, 2014, the maximum amount of future contingent consideration (undiscounted) that we could be required to pay was approximately $2.2 billion.

Contingent consideration liabilities are remeasured to fair value each reporting period using projected revenues, discount rates, probabilities of payment and projected payment dates. The recurring Level 3 fair value measurements of our contingent consideration liability include the following significant unobservable inputs:

Contingent Consideration Liability	Fair Value as of June 30, 2014	Valuation Technique	Unobservable Input	Range
R&D, Regulatory and Commercialization-based Milestones	$61 million	Probability Weighted Discounted Cash Flow	Discount Rate	0.9%-1.4%
			Probability of Payment	60% - 95%
			Projected Year of Payment	2014 - 2015
Revenue-based Payments	$69 million	Discounted Cash Flow	Discount Rate	11.5% - 15%
			Probability of Payment	0% - 100%
			Projected Year of Payment	2014 - 2018
	$242 million	Monte Carlo	Revenue Volatility	11% - 13%
			Risk Free Rate	LIBOR Term Structure
			Projected Year of Payment	2014-2018

Increases or decreases in the fair value of our contingent consideration liability can result from changes in discount periods and rates, as well as changes in the timing and amount of revenue estimates or in the timing or likelihood of achieving regulatory-, revenue- or commercialization-based milestones. Projected contingent payment amounts related to research and development, regulatory- and commercialization-based milestones and certain revenue-based milestones are discounted back to the current period using a discounted cash flow (DCF) model. Other revenue-based payments are valued using a Monte Carlo valuation model, which simulates future revenues during the earn-out period using management's best estimates. Projected revenues are based on our most recent internal operational budgets and long-range strategic plans. Increases in projected revenues and probabilities of payment may result in higher fair value measurements. Increases in discount rates and the time to payment may result in lower fair value measurements. Increases or decreases in any of those inputs in isolation may result in a significantly lower or higher fair value measurement.

NOTE C – DIVESTITURES

In January 2011, we closed the sale of our Neurovascular business to Stryker Corporation for a purchase price of $1.500 billion in cash. We received $1.450 billion during 2011, including an upfront payment of $1.426 billion, and $24 million which was placed into escrow and released throughout 2011 upon the completion of local closings in certain foreign jurisdictions. We received $10 million during 2012, $28 million during the second quarter of 2013 and we received the final $12 million of consideration in January 2014. At the time of divestiture, due to our continuing involvement in the operations of the Neurovascular business following the transaction, the divestiture did not meet the criteria for presentation as a discontinued operation. Our sales related to our divested Neurovascular business have declined as the various transition services and supply agreements have terminated.

Revenue generated by the Neurovascular business was $1 million in the second quarter of 2014, $3 million in the first half of 2014, $19 million in the second quarter of 2013, and $55 million in the first half of 2013.

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NOTE D – GOODWILL AND OTHER INTANGIBLE ASSETS

The gross carrying amount of goodwill and other intangible assets and the related accumulated amortization for intangible assets subject to amortization and accumulated write-offs of goodwill as of June 30, 2014 and December 31, 2013 are as follows:

	As of June 30, 2014		December 31, 2013	
(in millions)	Gross Carrying Amount	Accumulated Amortization/ Write-offs	Gross Carrying Amount	Accumulated Amortization/ Write-offs
Amortizable intangible assets				
Technology-related	$8,252	$(3,520)	$8,272	$(3,342)
Patents	522	(336)	513	(326)
Other intangible assets	847	(506)	845	(479)
	$9,621	$(4,362)	$9,630	$(4,147)
Unamortizable intangible assets				
Goodwill	$15,635	$(9,900)	$15,593	$(9,900)
Technology-related	197	—	197	—
	$15,832	$(9,900)	$15,790	$(9,900)

In addition, we had $203 million and $270 million of in-process research and development intangible assets as of June 30, 2014 and December 31, 2013, respectively.
The following represents our goodwill balance by global reportable segment:

(in millions)	Cardiovascular	Rhythm Management	MedSurg	Total
Balance as of December 31, 2013	$3,252	$294	$2,147	$5,693
Purchase price adjustments	—	(2)	—	(2)
Goodwill acquired	—	—	44	44
Goodwill written off	—	—	—	—
Other changes in carrying amount *	7	—	(7)	—
Balance as of June 30, 2014	$3,259	$292	$2,184	$5,735

* In the first half of 2014, we reallocated $7 million of goodwill between Cardiovascular and MedSurg as a result of the realignment of certain product lines from Endoscopy to Peripheral Interventions as of January 1, 2014.

2014 Goodwill Impairment Testing

We test our goodwill balances during the second quarter of each year for impairment, or more frequently if indicators are present or changes in circumstances suggest that impairment may exist.

In the second quarter of 2014, we performed our annual goodwill impairment test for all of our reporting units. In conjunction with our annual test, the fair value of each reporting unit exceeded its carrying value. As a result of the 2014 annual goodwill impairment test, we have identified our global Neuromodulation and global Electrophysiology reporting units as being at higher risk of potential failure of the first step of the goodwill impairment test in future reporting periods. Our global Neuromodulation reporting unit had excess fair value over carrying value of approximately 55 percent as of our annual test date and held $1.356 billion of allocated goodwill as of June 30, 2014. Our global Electrophysiology reporting unit had excess fair value over carrying value of approximately 38 percent as of our annual test date and held $292 million of allocated goodwill as of June 30, 2014. Our global Cardiac Rhythm Management (CRM) reporting unit had a fair value approximately equal to its carrying value; however, due to goodwill impairment charges in prior years, no goodwill remains within our CRM reporting unit. Changes in our reporting units or in the structure of our business as a result of future reorganizations, acquisitions or divestitures of assets or businesses could result in future impairments of goodwill within our reporting units including global CRM. Further, the recoverability of our CRM-related amortizable intangibles ($4.236 billion globally as of June 30, 2014) is sensitive to future cash flow assumptions and our global CRM business performance. The $4.236 billion of CRM-related amortizable intangibles are at higher risk of potential failure of the first step of the amortizable intangible recoverability test in future reporting periods. An impairment of a material portion of our CRM-related amortizable intangibles carrying value would occur if the second step of the amortizable intangible test is required in a future reporting period. Refer to Critical Accounting Policies and Estimates within our Management's

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Discussion and Analysis of Financial Condition and Results of Operations contained in Item 2 of this Quarterly Report on Form 10-Q for a discussion of key assumptions used in our testing.

On a quarterly basis, we monitor the key drivers of fair value to detect events or other changes that would warrant an interim impairment test of our goodwill and intangible assets. The key variables that drive the cash flows of our reporting units and amortizable intangibles are estimated revenue growth rates and levels of profitability. Terminal value growth rate assumptions, as well as the Weighted Average Cost of Capital (WACC) rate applied are additional key variables for reporting unit cash flows. These assumptions are subject to uncertainty, including our ability to grow revenue and improve profitability levels. Relatively
small declines in the future performance and cash flows of a reporting unit or asset group or small changes in other key assumptions may result in the recognition of significant goodwill or intangible asset impairment charges. For example, keeping all other variables constant, an increase in the WACC applied of 100 basis points combined with a 150 basis point decrease in the terminal value growth rate would require that we perform the second step of the goodwill impairment test for both our global Electrophysiology and global Neuromodulation reporting units. The estimates used for our future cash flows and discount rates represent management's best estimates, which we believe to be reasonable, but future declines in business performance may impair the recoverability of our goodwill and intangible asset balances.

Future events that could have a negative impact on the levels of excess fair value over carrying value of our reporting units and/or amortizable intangible assets include, but are not limited to:

- decreases in estimated market sizes or market growth rates due to greater-than-expected declines in procedural volumes, pricing pressures, reductions in reimbursement levels, product actions, and/or competitive technology developments;
- declines in our market share and penetration assumptions due to increased competition, an inability to develop or launch new and next-generation products and technology features in line with our commercialization strategies, and market and/or regulatory conditions that may cause significant launch delays or product recalls;
- decreases in our forecasted profitability due to an inability to successfully implement and achieve timely and sustainable cost improvement measures consistent with our expectations, increases in our market-participant tax rate, and/or changes in tax laws;