GILEAD SCIENCES INC
Form 10-Q
October 31, 2013

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

FORM 10-Q

ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2013

or

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ________ to ________

Commission File No. 0-19731

GILEAD SCIENCES, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	94-3047598 (IRS Employer Identification No.)
333 Lakeside Drive, Foster City, California (Address of principal executive offices)	94404 (Zip Code)

650-574-3000
Registrant’s Telephone Number, Including Area Code

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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 ý Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company ¨
(Do not check if a smaller reporting company)

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

Number of shares outstanding of the issuer's common stock, par value $0.001 per share, as of October 18, 2013: 1,533,349,106

GILEAD SCIENCES, INC.
INDEX

PART I.	FINANCIAL INFORMATION		2
	Item 1.	Condensed Consolidated Financial Statements	2
		Condensed Consolidated Balance Sheets at September 30, 2013 and December 31, 2012	2
		Condensed Consolidated Statements of Income for the Three and Nine Months Ended September 30, 2013 and 2012	3
		Condensed Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2013 and 2012	4
		Condensed Statements of Cash Flows for the Nine Months Ended September 30, 2013 and 2012	5
		Notes to Condensed Consolidated Financial Statements	6
	Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	23
	Item 3.	Quantitative and Qualitative Disclosures About Market Risk	32
	Item 4.	Controls and Procedures	32
PART II.	OTHER INFORMATION		33
	Item 1.	Legal Proceedings	33
	Item 1A.	Risk Factors	37
	Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	53
	Item 3.	Defaults Upon Senior Securities	53
	Item 4.	Mine Safety Disclosures	53
	Item 5.	Other Information	53
	Item 6.	Exhibits	54
SIGNATURES			63

We own or have rights to various trademarks, copyrights and trade names used in our business, including the following: GILEAD®, GILEAD SCIENCES®, STRIBILD®, COMPLERA®, EVIPLERA®, TRUVADA®, VIREAD®, TYBOST®, HEPSERA®, EMTRIVA®, LETAIRIS®, RANEXA®, AMBISOME®, CAYSTON®, VISTIDE®, VOLIBRIS® and RAPISCAN®. ATRIPLA® is a registered trademark belonging to Bristol-Myers Squibb & Gilead

Sciences, LLC. LEXISCAN® is a registered trademark belonging to Astellas U.S. LLC. MACUGEN® is a registered trademark belonging to Eyetech, Inc. SUSTIVA® is a registered trademark of Bristol-Myers Squibb Pharma Company. TAMIFLU® is a registered trademark belonging to Hoffmann-La Roche Inc. This report also includes other trademarks, service marks and trade names of other companies.

PART I. FINANCIAL INFORMATION
ITEM I. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
GILEAD SCIENCES, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except per share amounts)

	September 30, 2013 (unaudited)	December 31, 2012
Assets		
Current assets:		
Cash and cash equivalents	$2,010,736	$1,803,694
Short-term marketable securities	79,758	58,556
Accounts receivable, net	1,971,926	1,751,388
Inventories	1,946,048	1,744,982
Deferred tax assets	239,287	262,641
Prepaid taxes	462,704	348,420
Prepaid expenses	148,407	102,364
Other current assets	109,195	84,302
Total current assets	6,968,061	6,156,347
Property, plant and equipment, net	1,133,032	1,100,259
Long-term portion of prepaid royalties	177,450	175,790
Long-term deferred tax assets	162,738	131,107
Long-term marketable securities	665,063	719,836
Intangible assets, net	12,034,457	11,736,393
Goodwill	1,188,157	1,060,919
Other long-term assets	139,470	159,187
Total assets	$22,468,428	$21,239,838
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$1,350,402	$1,327,339
Accrued government rebates	904,421	745,148
Accrued compensation and employee benefits	228,245	236,716
Income taxes payable	10,651	13,403
Other accrued liabilities	816,748	674,762
Deferred revenues	127,278	103,162
Current portion of long-term debt and other obligations, net	1,457,379	1,169,490
Total current liabilities	4,895,124	4,270,020
Long-term deferred revenues	25,398	20,532
Long-term debt, net	5,856,093	7,054,555
Long-term income taxes payable	119,589	115,822
Long-term deferred tax liabilities	118,660	10,190
Other long-term obligations	261,091	217,850
Commitments and contingencies (Note 10)		
Stockholders' equity:		
Preferred stock, par value $0.001 per share; 5,000 shares authorized; none outstanding	—	—
Common stock, par value $0.001 per share; 5,600,000 shares authorized; 1,534,028 and 1,519,163 shares issued and outstanding	763	760

Additional paid-in capital	5,189,582	5,649,850
Accumulated other comprehensive loss	(42,070)	(45,615)
Retained earnings	5,735,335	3,704,744
Total Gilead stockholders' equity	10,883,610	9,309,739
Noncontrolling interest	308,863	241,130
Total stockholders' equity	11,192,473	9,550,869
Total liabilities and stockholders' equity	$22,468,428	$21,239,838

See accompanying notes.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Revenues:				
Product sales	$2,709,652	$2,357,978	$7,760,505	$6,887,560
Royalty revenues	69,779	63,915	310,700	216,126
Contract and other revenues	3,402	4,704	10,657	10,546
Total revenues	2,782,833	2,426,597	8,081,862	7,114,232
Costs and expenses:				
Cost of goods sold	681,868	597,269	2,000,979	1,795,545
Research and development	546,244	465,831	1,567,778	1,320,286
Selling, general and administrative	406,860	319,583	1,186,147	1,095,209
Total costs and expenses	1,634,972	1,382,683	4,754,904	4,211,040
Income from operations	1,147,861	1,043,914	3,326,958	2,903,192
Interest expense	(73,949)	(89,322)	(233,744)	(275,010)
Other income (expense), net	5,777	(3,505)	2,222	(38,665)
Income before provision for income taxes	1,079,689	951,087	3,095,436	2,589,517
Provision for income taxes	294,473	280,052	824,892	774,877
Net income	785,216	671,035	2,270,544	1,814,640
Net loss attributable to noncontrolling interest	3,390	4,470	12,853	14,385
Net income attributable to Gilead	$788,606	$675,505	$2,283,397	$1,829,025
Net income per share attributable to Gilead common stockholders—basic	$0.51	$0.45	$1.50	$1.21
Shares used in per share calculation—basic	1,532,105	1,514,770	1,526,847	1,514,064
Net income per share attributable to Gilead common stockholders—diluted	$0.47	$0.43	$1.35	$1.17
Shares used in per share calculation—diluted	1,691,898	1,584,608	1,689,647	1,567,648

See accompanying notes.

GILEAD SCIENCES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(unaudited)
(in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net income	$785,216	$671,035	$2,270,544	$1,814,640
Other comprehensive income:				
Net foreign currency translation gain, net of tax	2,381	5,090	5,155	7,346
Available-for-sale securities:				
Net unrealized gain, net of tax impact of $2,182, $(848), $2,310 and $(660)	4,316	1,476	4,082	1,146
Reclassifications to net income, net of tax impact of $(38), $1,396, $(79) and $849	(65)	2,429	(140)	32,979
Net change	4,251	3,905	3,942	34,125
Cash flow hedges:				
Net unrealized loss, net of tax impact of $6,083, $3,180, $2,504 and $460	(82,453)	(67,674)	(3,371)	(9,084)
Reclassifications to net income, net of tax impact of $(358), $(1,760), $(610) and $(3,156)	3,380	(37,449)	(2,181)	(62,338)
Net change	(79,073)	(105,123)	(5,552)	(71,422)
Other comprehensive income (loss)	(72,441)	(96,128)	3,545	(29,951)
Comprehensive income	712,775	574,907	2,274,089	1,784,689
Comprehensive loss attributable to noncontrolling interest	3,390	4,470	12,853	14,385
Comprehensive income attributable to Gilead	$716,165	$579,377	$2,286,942	$1,799,074

See accompanying notes.

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

	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
Operating Activities:		
Net income	$2,270,544	$1,814,640
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	76,046	60,488
Amortization expense	140,699	144,087
Stock-based compensation expense	180,293	151,598
Excess tax benefits from stock-based compensation	(168,728)	(64,955)
Tax benefits from employee stock plans	169,916	61,401
Deferred income taxes	(12,400)	21,374
Other	45,116	(2,037)
Changes in operating assets and liabilities:		
Accounts receivable, net	(226,308)	160,831
Inventories	(216,650)	(224,742)
Prepaid expenses and other assets	(111,199)	(109,550)
Accounts payable	23,131	146,458
Income taxes payable	(87,081)	(75,674)
Accrued liabilities	265,765	397,831
Deferred revenues	29,057	7,238
Net cash provided by operating activities	2,378,201	2,488,988
Investing Activities:		
Purchases of marketable securities	(254,657)	(1,148,751)
Proceeds from sales of marketable securities	226,291	130,463
Proceeds from maturities of marketable securities	57,556	25,975
Purchases of other investments	—	(25,000)
Acquisitions, net of cash acquired	(378,645)	(10,751,636)
Capital expenditures	(121,310)	(127,175)
Net cash used in investing activities	(470,765)	(11,896,124)
Financing Activities:		
Proceeds from debt financing, net of issuance costs	—	2,144,733
Proceeds from convertible note hedges	1,257,869	—
Proceeds from issuances of common stock	240,671	350,264
Repurchases of common stock	(182,259)	(467,000)
Repayments of debt financing	(2,224,724)	(1,050,000)
Payments to settle warrants	(1,039,695)	—
Repayments of other long-term obligations	(58)	(2,167)
Excess tax benefits from stock-based compensation	168,728	64,955
Contributions from (distributions to) noncontrolling interest	80,586	32,412
Net cash provided by (used in) financing activities	(1,698,882)	1,073,197
Effect of exchange rate changes on cash	(1,512)	872
Net change in cash and cash equivalents	207,042	(8,333,067)

Cash and cash equivalents at beginning of period	1,803,694	9,883,777
Cash and cash equivalents at end of period	$2,010,736	$1,550,710

See accompanying notes.

GILEAD SCIENCES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
Basis of Presentation
The accompanying unaudited Condensed Consolidated Financial Statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information. The financial statements include all adjustments (consisting only of normal recurring adjustments) that the management of Gilead Sciences, Inc. (Gilead, we or us) believes are necessary for a fair presentation of the periods presented. These interim financial results are not necessarily indicative of results expected for the full fiscal year or for any subsequent interim period.
The accompanying Condensed Consolidated Financial Statements include the accounts of Gilead, our wholly-owned subsidiaries and our joint ventures with Bristol-Myers Squibb Company (BMS), for which we are the primary beneficiary. We record a noncontrolling interest in our Condensed Consolidated Financial Statements to reflect BMS's interest in the joint ventures. All intercompany transactions have been eliminated. The Condensed Consolidated Financial Statements include the results of companies acquired by us from the date of each acquisition for the applicable reporting periods.
The accompanying Condensed Consolidated Financial Statements and related Notes to Condensed Consolidated Financial Statements should be read in conjunction with the audited Consolidated Financial Statements and the related notes thereto for the year ended December 31, 2012, included in our Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission.
Significant Accounting Policies, Estimates and Judgments
The preparation of these Condensed Consolidated Financial Statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures. On an ongoing basis, management evaluates its significant accounting policies or estimates. We base our estimates on historical experience and on various market specific and other relevant assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ significantly from these estimates.
Net Income Per Share Attributable to Gilead Common Stockholders
Basic net income per share attributable to Gilead common stockholders is calculated based on the weighted-average number of shares of our common stock outstanding during the period. Diluted net income per share attributable to Gilead common stockholders is calculated based on the weighted-average number of shares of our common stock outstanding and other dilutive securities outstanding during the period. The potential dilutive shares of our common stock resulting from the assumed exercise of outstanding stock options, performance shares and the assumed exercise of warrants relating to the convertible senior notes due in May 2013 (May 2013 Notes), May 2014 (May 2014 Notes) and May 2016 (May 2016 Notes) (collectively, the Convertible Notes) are determined under the treasury stock method.
Because the principal amount of the Convertible Notes will be settled in cash, only the conversion spread relating to the Convertible Notes is included in our calculation of diluted net income per share attributable to Gilead common stockholders. Our common stock resulting from the assumed settlement of the conversion spread of the Convertible Notes has a dilutive effect when the average market price of our common stock during the period exceeds the conversion price of $22.54 for the May 2014 Notes and $22.71 for the May 2016 Notes. Warrants relating to the Convertible Notes have a dilutive effect when the average market price of our common stock during the period exceeds the warrants' exercise price of $28.38 for the May 2014 Notes and $30.05 for the May 2016 Notes.
Our May 2013 Notes matured and as a result, we have only included their impact for the period they were outstanding on our net income per share calculations for the nine months ended September 30, 2013. Our common stock resulting from the assumed settlement of the conversion spread of the May 2013 Notes had a dilutive effect when the average market price of our common stock during the period exceeded the conversion price of $19.05. Warrants related to our May 2013 Notes settled in August 2013 and as a result, we have only included their impact for the period they were outstanding on our net income per share calculation for the three and nine months ended September 30, 2013. The related warrants had a dilutive effect when the average market price of our common stock during the period exceeded

the warrants’ exercise price of $26.95.

We have excluded stock options to purchase 0.1 million weighted-average shares of our common stock that were outstanding during the three months ended September 30, 2013, 0.9 million shares during the nine months ended September 30, 2013, 4.2 million shares during three months ended September 30, 2012 and 11.5 million shares during the nine months ended

6

September 30, 2012 in the computation of diluted net income per share attributable to Gilead common stockholders because their effect was antidilutive.

The following table is a reconciliation of the numerator and denominator used in the calculation of basic and diluted net income per share attributable to Gilead common stockholders (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Numerator:				
Net income attributable to Gilead	$788,606	$675,505	$2,283,397	$1,829,025
Denominator:				
Weighted-average shares of common stock outstanding used in the calculation of basic net income per share attributable to Gilead common stockholders	1,532,105	1,514,770	1,526,847	1,514,064
Effect of dilutive securities:				
Stock options and equivalents	38,575	32,478	39,085	30,926
Conversion spread related to the May 2013 Notes	—	11,446	5,268	8,950
Conversion spread related to the May 2014 Notes	24,335	11,860	27,435	7,058
Conversion spread related to the May 2016 Notes	33,873	11,452	30,587	6,650
Warrants related to the Convertible Notes	63,010	2,602	60,425	—
Weighted-average shares of common stock outstanding used in the calculation of diluted net income per share attributable to Gilead common stockholders	1,691,898	1,584,608	1,689,647	1,567,648

Concentrations of Risk

We are subject to credit risk from our portfolio of cash equivalents and marketable securities. Under our investment policy, we limit amounts invested in such securities by credit rating, maturity, industry group, investment type and issuer, except for securities issued by the U.S. government. We are not exposed to any significant concentrations of credit risk from these financial instruments. The goals of our investment policy, in order of priority, are as follows: safety and preservation of principal and diversification of risk; liquidity of investments sufficient to meet cash flow requirements; and a competitive after-tax rate of return.

We are also subject to credit risk from our accounts receivable related to our product sales. The majority of our trade accounts receivable arises from product sales in the United States and Europe.

As of September 30, 2013, our accounts receivable in Southern Europe, specifically Greece, Italy, Portugal and Spain, totaled approximately $939.9 million, of which $429.3 million were greater than 120 days past due and $179.9 million were greater than 365 days past due. To date, we have not experienced significant losses with respect to the collection of our accounts receivable. We believe that our allowance for doubtful accounts was adequate at September 30, 2013.

Recent Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board (FASB) issued an update to the existing standard for liabilities. The update provides guidance for the recognition, measurement and disclosure of obligations resulting from joint and several liability arrangements. For obligations for which the total amount is fixed at the reporting date, an entity will be required to measure those obligations as the sum of the amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors and any additional amount the reporting entity expects to pay on behalf of its co-obligors. Such entities will also be required to disclose the nature, amount and other significant information about the obligations. This guidance will become effective for us beginning in the first quarter of 2014. We believe that the adoption of this update will not have a material impact on our Consolidated Financial Statements.

In July 2013, the FASB issued an update related to presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss or a tax credit carryforward exists. An unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. This guidance will become effective for us beginning in the first quarter of 2014. We believe that the adoption of this update will not have a material impact on our Consolidated Financial Statements.

2. FAIR VALUE MEASUREMENTS

We determine the fair value of financial and non-financial assets and liabilities using the fair value hierarchy, which establishes three levels of inputs that may be used to measure fair value, as follows:

- Level 1 inputs which include quoted prices in active markets for identical assets or liabilities;
- Level 2 inputs which include observable inputs other than Level 1 inputs, such as quoted prices for similar assets or liabilities; quoted prices for identical or similar assets or liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability. For our marketable securities, we review trading activity and pricing as of the measurement date. When sufficient quoted pricing for identical securities is not available, we use market pricing and other observable market inputs for similar securities obtained from various third-party data providers. These inputs either represent quoted prices for similar assets in active markets or have been derived from observable market data; and
- Level 3 inputs which include unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the underlying asset or liability. Level 3 assets and liabilities include those whose fair value measurements are determined using pricing models, discounted cash flow methodologies or similar valuation techniques and significant management judgment or estimation.

Our financial instruments consist principally of cash and cash equivalents, marketable securities, accounts receivable, foreign currency exchange forward and option contracts, accounts payable and short-term and long-term debt. Cash and cash equivalents, marketable securities and foreign currency exchange contracts that hedge accounts receivable and forecasted sales are reported at their respective fair values on our Condensed Consolidated Balance Sheets. Short-term and long-term debt are reported at their amortized cost on our Condensed Consolidated Balance Sheets. The remaining financial instruments are reported on our Condensed Consolidated Balances Sheets at amounts that approximate current fair values.

The fair values of our Convertible Notes and senior unsecured notes were determined using Level 2 inputs based on their quoted market values. The following table summarizes the carrying values and fair values of the Convertible Notes and senior unsecured notes (in thousands):

		September 30, 2013		December 31, 2012	
Type of Borrowing	Description	Carrying Value	Fair Value	Carrying Value	Fair Value
Convertible Senior	May 2013 Notes	$—	$—	$419,433	$815,297
Convertible Senior	May 2014 Notes	857,322	2,443,534	1,210,213	2,040,363
Convertible Senior	May 2016 Notes	1,168,117	3,464,641	1,157,692	2,110,938
Senior Unsecured	April 2021 Notes	993,567	1,079,470	992,923	1,146,990
Senior Unsecured	December 2014 Notes	749,631	765,015	749,394	772,650
Senior Unsecured	December 2016 Notes	699,268	738,171	699,095	748,902
Senior Unsecured	December 2021 Notes	1,247,644	1,336,600	1,247,428	1,420,725
Senior Unsecured	December 2041 Notes	997,866	1,111,730	997,810	1,252,090

The following table summarizes, for assets or liabilities recorded at fair value, the respective fair value and the classification by level of input within the fair value hierarchy defined above (in thousands):

	September 30, 2013				December 31, 2012			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Assets:								
Debt securities:								
U.S. Treasury securities	$160,274	$—	$—	$160,274	$81,903	$—	$—	$81,903
Money market funds	1,547,868	—	—	1,547,868	1,416,355	—	—	1,416,355
U.S. government agencies securities	—	146,778	—	146,778	—	248,952	—	248,952
Municipal debt securities	—	12,018	—	12,018	—	12,088	—	12,088
Corporate debt securities	—	366,682	—	366,682	—	352,718	—	352,718
Residential mortgage and asset-backed securities	—	78,319	—	78,319	—	82,732	—	82,732
Total debt securities	1,708,142	603,797	—	2,311,939	1,498,258	696,490	—	2,194,748
Derivatives	—	8,985	—	8,985	—	14,823	—	14,823
	$1,708,142	$612,782	$—	$2,320,924	$1,498,258	$711,313	$—	$2,209,571
Liabilities:								
Contingent consideration	$—	$—	$252,502	$252,502	$—	$—	$205,060	$205,060
Derivatives	—	61,107	—	61,107	—	65,248	—	65,248
	$—	$61,107	$252,502	$313,609	$—	$65,248	$205,060	$270,308

Level 2 Inputs

We estimate the fair values of our government related debt, corporate debt, residential mortgage and asset-backed securities by taking into consideration valuations obtained from third-party pricing services. The pricing services utilize industry standard valuation models, including both income- and market-based approaches, for which all significant inputs are observable, either directly or indirectly, to estimate fair value. These inputs include reported trades of and broker/dealer quotes on the same or similar securities; issuer credit spreads; benchmark securities; prepayment/default projections based on historical data; and other observable inputs.

Substantially all of our foreign currency derivatives contracts have maturities primarily over an 18-month time horizon and all are with counterparties that have a minimum credit rating of A- or equivalent by Standard & Poor's, Moody's Investors Service, Inc. or Fitch, Inc. We estimate the fair values of these contracts by taking into consideration valuations obtained from a third-party valuation service that utilizes an income-based industry standard valuation model for which all significant inputs are observable, either directly or indirectly. These inputs include foreign currency rates, London Interbank Offered Rates (LIBOR) and swap rates. These inputs, where applicable, are at commonly quoted intervals.

Level 3 Inputs

As of September 30, 2013 and December 31, 2012, the only assets or liabilities that were measured using Level 3 inputs were contingent consideration liabilities. During 2012, we held auction rate securities and Greek government bonds which were measured at fair value using Level 3 inputs. Our policy is to recognize transfers into or out of Level 3 classification as of the actual date of the event or change in circumstances that caused the transfer.

Auction Rate Securities

During the third quarter of 2012, we sold our remaining portfolio of auction rate securities and as a result of the sale, we received total proceeds of $37.3 million which resulted in a $3.8 million loss that was recognized in other income (expense), net on our Condensed Consolidated Statements of Income.

The underlying assets of our auction rate securities consisted of student loans. Although auction rate securities would typically be measured using Level 2 inputs, the failure of auctions and the lack of market activity and liquidity experienced since the beginning of 2008 required that these securities be measured using Level 3 inputs. The fair value of our auction rate securities was determined using a discounted cash flow model that considered projected cash flows for the issuing trusts, underlying collateral and expected yields. Projected cash flows were estimated based on the underlying loan principal, bonds outstanding and payout formulas. The weighted-average life over which the cash flows were projected considered the collateral composition of the securities and related historical and projected prepayments.

Greek Government Bonds

During the first quarter of 2012, the Greek government restructured its sovereign debt which impacted all holders of Greek bonds. As a result, we recorded a $40.1 million loss related to the debt restructuring as part of other income (expense), net on our Condensed Consolidated Statements of Income and exchanged the Greek government-issued bonds for new securities, which we liquidated during the first quarter of 2012. We estimated the fair value of the Greek zero-coupon bonds using Level 3 inputs due to the then current lack of market activity and liquidity. The discount rates used in our fair value model for these bonds were based on credit default swap rates.

Contingent Consideration Liabilities

In connection with certain acquisitions, we may be required to pay future consideration that is contingent upon the achievement of specified development, regulatory approval or sales-based milestone events. We estimate the fair value of the contingent consideration liabilities on the acquisition date and each reporting period thereafter using a probability-weighted income approach, which reflects the probability and timing of future payments. This fair value measurement is based on significant Level 3 inputs such as the anticipated timelines and probability of achieving development, regulatory approval or sales-based milestone events and projected revenues. The resulting probability-weighted cash flows are discounted using credit-risk adjusted interest rates.

Each reporting period thereafter, we revalue these obligations by performing a review of the assumptions listed above and record increases or decreases in the fair value of these contingent consideration obligations in research and development (R&D) expenses within our Condensed Consolidated Statements of Income until such time that the related product candidate receives marketing approval. In the absence of any significant changes in key assumptions, the quarterly determination of fair values of these contingent consideration obligations would primarily reflect the passage of time.

Significant judgment is employed in determining Level 3 inputs and fair value measurements as of the acquisition date and for each subsequent period. Updates to assumptions could have a significant impact on our results of operations in any given period and actual results may differ from estimates. For example, significant increases in the probability of achieving a milestone or projected revenues would result in a significantly higher fair value measurement while significant decreases in the estimated probability of achieving a milestone or projected revenues would result in a significantly lower fair value measurement. Significant increases in the discount rate or in the anticipated timelines would result in a significantly lower fair value measurement while significant decreases in the discount rate or anticipated timelines would result in a significantly higher fair value measurement.

The potential contingent consideration payments required upon achievement of development or regulatory approval-based milestones related to our CGI Pharmaceuticals, Inc. and Calistoga Pharmaceuticals, Inc. acquisitions range from no payment if none of the milestones are achieved to an estimated maximum of $254.0 million (undiscounted), of which we had accrued $190.8 million as of September 30, 2013 and $159.3 million as of December 31, 2012. The remainder of the contingent consideration liabilities accrual as of September 30, 2013 and December 31, 2012 relates to potential future payments resulting from the acquisition of Arresto Biosciences, Inc. for royalty obligations on future sales once specified sales-based milestones are achieved.

The following table provides a rollforward of our contingent consideration liabilities, which are recorded as part of other long-term obligations in our Condensed Consolidated Balance Sheets (in thousands):

Balance at December 31, 2012	$205,060
Additions from new acquisitions	—
Net changes in valuation	47,442

Balance at September 30, 2013	$252,502

3. AVAILABLE-FOR-SALE SECURITIES

The following table is a summary of available-for-sale debt securities recorded in cash and cash equivalents or marketable securities in our Condensed Consolidated Balance Sheets (in thousands):

	September 30, 2013				December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Debt securities:								
U.S. Treasury securities	$160,177	$191	$(94)	$160,274	$81,752	$151	$—	$81,903
Money market funds	1,547,868	—	—	1,547,868	1,416,356	—	—	1,416,356
U.S. government agencies securities	146,414	364	—	146,778	248,595	386	(29)	248,952
Municipal debt securities	12,022	3	(7)	12,018	12,062	33	(7)	12,088
Corporate debt securities	365,726	1,161	(205)	366,682	351,309	1,492	(84)	352,717
Residential mortgage and asset-backed securities	78,478	28	(187)	78,319	82,717	156	(141)	82,732
Total	$2,310,685	$1,747	$(493)	$2,311,939	$2,192,791	$2,218	$(261)	$2,194,748

Estimated fair values of available-for-sale securities are generally based on prices obtained from commercial pricing services. The following table summarizes the classification of the available-for-sale debt securities on our Condensed Consolidated Balance Sheets (in thousands):

	September 30, 2013	December 31, 2012
Cash and cash equivalents	$1,567,118	$1,416,356
Short-term marketable securities	79,758	58,556
Long-term marketable securities	665,063	719,836
Total	$2,311,939	$2,194,748

Cash and cash equivalents in the table above exclude cash of $443.6 million as of September 30, 2013 and $387.3 million as of December 31, 2012.

The following table summarizes our portfolio of available-for-sale debt securities by contractual maturity (in thousands):

	September 30, 2013	
	Amortized Cost	Fair Value
Less than one year	$1,646,748	$1,646,876
Greater than one year but less than five years	652,601	653,837
Greater than five years but less than ten years	—	—
Greater than ten years	11,336	11,226
Total	$2,310,685	$2,311,939

The following table summarizes the gross realized gains and losses related to sales of marketable securities (in thousands):

	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
Gross realized gains on sales	$269	$25	$652	$10,124
Gross realized losses on sales	$(166)	$(3,850)	$(433)	$(43,951)

The cost of securities sold was determined based on the specific identification method.

The following table summarizes our available-for-sale debt securities that were in a continuous unrealized loss position, but were not deemed to be other-than-temporarily impaired (in thousands):

	Less Than 12 Months		12 Months or Greater		Total	
	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value
September 30, 2013						
Debt securities:						
U.S. Treasury securities	$(94)	$41,591	$—	$—	$(94)	$41,591
Municipal debt securities	(7)	9,168	—	—	(7)	9,168
Corporate debt securities	(205)	88,186	—	2,026	(205)	90,212
Residential mortgage and asset-backed securities	(67)	42,029	(120)	12,441	(187)	54,470
Total	$(373)	$180,974	$(120)	$14,467	$(493)	$195,441
December 31, 2012						
Debt securities:						
U.S. government agencies securities	$(29)	$26,306	$—	$—	$(29)	$26,306
Municipal debt securities	(7)	3,993	—	—	(7)	3,993
Corporate debt securities	(84)	72,722	—	—	(84)	72,722
Residential mortgage and asset-backed securities	(141)	36,415	—	—	(141)	36,415
Total	$(261)	$139,436	$—	$—	$(261)	$139,436

We held a total of 68 securities that were in an unrealized loss position as of September 30, 2013 compared to 47 securities as of December 31, 2012. Based on our review of these securities, we believe we had no other-than-temporary impairments on these securities as of September 30, 2013 and December 31, 2012, because we do not intend to sell these securities and it is not more likely than not that we will be required to sell these securities before the recovery of their amortized cost basis.

4. DERIVATIVE FINANCIAL INSTRUMENTS

We operate in foreign countries, which exposes us to market risk associated with foreign currency exchange rate fluctuations between the U.S. dollar and various foreign currencies, the most significant of which is the Euro. In order to manage this risk, we may hedge a portion of our foreign currency exposures related to outstanding monetary assets and liabilities as well as forecasted product sales using foreign currency exchange forward or option contracts. In general, the market risk related to these contracts is offset by corresponding gains and losses on the hedged transactions. The credit risk associated with these contracts is driven by changes in interest and currency exchange rates and, as a result, varies over time. By working only with major banks and closely monitoring current market conditions, we limit the risk that counterparties to these contracts may be unable to perform. We also limit our risk of loss by entering into contracts that permit net settlement at maturity. Therefore, our overall risk of loss in the event of a counterparty default is limited to the amount of any unrecognized gains on outstanding contracts (i.e., those contracts that have a positive fair value) at the date of default. We do not enter into derivative contracts for trading purposes.

We hedge our exposure to foreign currency exchange rate fluctuations for certain monetary assets and liabilities of our foreign subsidiaries that are denominated in a non-functional currency. The derivative instruments we use to hedge this exposure are not designated as hedges, and as a result, changes in their fair value are recorded in other income (expense), net on our Condensed Consolidated Statements of Income.

We hedge our exposure to foreign currency exchange rate fluctuations for forecasted product sales that are denominated in a non-functional currency. The derivative instruments we use to hedge this exposure are designated as cash flow hedges and have maturity dates of 18 months or less. Upon executing a hedging contract and quarterly thereafter, we assess prospective hedge effectiveness using a regression analysis which calculates the change in cash flow as a result of the hedge instrument. On a monthly basis, we assess retrospective hedge effectiveness using a dollar offset approach. We exclude time value from our effectiveness testing and recognize changes in the time value of the hedge in other income (expense), net. The effective component of our hedge is recorded as an unrealized gain or loss on the hedging instrument in accumulated other comprehensive income (OCI) within stockholders' equity. When the hedged forecasted transaction occurs, the hedge is de-designated and the unrealized gains or losses are reclassified into product sales. The majority of gains and losses related to the hedged forecasted transactions reported in accumulated OCI at September 30, 2013 will be reclassified to product sales within 12 months.

The cash flow effects of our derivatives contracts for the nine months ended September 30, 2013 and 2012 are included within net cash provided by operating activities in the Condensed Consolidated Statements of Cash Flows. We had notional amounts on foreign currency exchange contracts outstanding of $3.79 billion at September 30, 2013 and $3.39 billion at December 31, 2012.

While all of our derivative contracts allow us the right to offset assets or liabilities, we have presented amounts on a gross basis. Under the International Swap Dealers Association, Inc. master agreements with the respective counterparties of the foreign currency exchange contracts, subject to applicable requirements, we are allowed to net settle transactions of the same currency with a single net amount payable by one party to the other. The following table summarizes the location and fair values of derivative instruments on our Condensed Consolidated Balance Sheets (in thousands):

	September 30, 2013			
	Asset Derivatives		Liability Derivatives	
	Classification	Fair Value	Classification	Fair Value
Derivatives designated as hedges:				
Foreign currency exchange contracts	Other current assets	$8,389	Other accrued liabilities	$52,385
Foreign currency exchange contracts	Other long-term assets	596	Other long-term obligations	8,687
Total derivatives designated as hedges		8,985		61,072
Derivatives not designated as hedges:				
Foreign currency exchange contracts	Other current assets	—	Other accrued liabilities	35
Total derivatives not designated as hedges		—		35
Total derivatives		$8,985		$61,107

	December 31, 2012			
	Asset Derivatives		Liability Derivatives	
	Classification	Fair Value	Classification	Fair Value
Derivatives designated as hedges:				
Foreign currency exchange contracts	Other current assets	$14,556	Other accrued liabilities	$54,597
Foreign currency exchange contracts	Other long-term assets	142	Other long-term obligations	10,630
Total derivatives designated as hedges		14,698		65,227
Derivatives not designated as hedges:				
Foreign currency exchange contracts	Other current assets	125	Other accrued liabilities	21
Total derivatives not designated as hedges		125		21
Total derivatives		$14,823		$65,248

The following table summarizes the effect of our foreign currency exchange contracts on our Condensed Consolidated Statements of Income (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Derivatives designated as hedges:				