BOSTON SCIENTIFIC CORP
Form 10-Q
August 03, 2016
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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, 2016
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)

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	Smaller reporting company o
		(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 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 29, 2016
Common Stock, $.01 par value	1,360,743,339

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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	2016	2015	2016	2015
Net sales	$2,126	$1,843	$4,090	$3,611
Cost of products sold	639	540	1,211	1,060
Gross profit	1,487	1,303	2,879	2,551
Operating expenses:				
Selling, general and administrative expenses	779	700	1,497	1,367
Research and development expenses	222	220	431	412
Royalty expense	20	18	39	36
Amortization expense	135	116	271	229
Intangible asset impairment charges	—	9	—	9
Contingent consideration expense (benefit)	33	19	37	46
Restructuring charges	14	3	17	9
Litigation-related charges (credits)	618	(1)	628	192
Pension termination charges	—	—	—	8
	1,821	1,084	2,920	2,308
Operating income (loss)	(334)	219	(41)	243
Other income (expense):				
Interest expense	(59)	(106)	(118)	(167)
Other, net	(4)	(8)	(10)	(22)
Income (loss) before income taxes	(397)	105	(169)	54
Income tax expense (benefit)	(190)	3	(164)	(47)
Net income (loss)	$(207)	$102	$(5)	$101
Net income (loss) per common share — basic	$(0.15)	$0.08	$(0.00)	$0.08
Net income (loss) per common share — assuming dilution	$(0.15)	$0.08	$(0.00)	$0.07
Weighted-average shares outstanding				
Basic	1,357.4	1,341.3	1,353.9	1,337.5
Assuming dilution	1,357.4	1,361.8	1,353.9	1,359.7

See notes to the unaudited condensed consolidated financial statements.

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)	2016	2015	2016	2015
Net income (loss)	$(207)	$102	$(5)	$101
Other comprehensive income (loss):				
Foreign currency translation adjustment	(21)	5	(5)	(30)
Net change in unrealized gains and losses on derivative financial instruments, net of tax	(84)	(43)	(153)	(15)
Net change in certain retirement plans, net of tax	—	—	—	5
Total other comprehensive income (loss)	(105)	(38)	(158)	(40)
Total comprehensive income (loss)	$(312)	$64	$(163)	$61

See notes to the unaudited condensed consolidated financial statements.

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BOSTON SCIENTIFIC CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

	As of	
	June 30,	December 31,
in millions, except share and per share data	2016	2015
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$438	$319
Trade accounts receivable, net	1,387	1,275
Inventories	981	1,016
Deferred and prepaid income taxes	78	496
Other current assets	446	365
Total current assets	3,330	3,471
Property, plant and equipment, net	1,487	1,490
Goodwill	6,475	6,473
Other intangible assets, net	5,930	6,194
Other long-term assets	616	505
TOTAL ASSETS	$17,838	$18,133
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Current liabilities:		
Current debt obligations	$254	$3
Accounts payable	284	209
Accrued expenses	2,236	1,970
Other current liabilities	408	248
Total current liabilities	3,182	2,430
Long-term debt	5,173	5,674
Deferred income taxes	24	735
Other long-term liabilities	3,239	2,974
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 - issued 1,606,264,833 shares as of June 30, 2016 and 1,594,213,786 shares as of December 31, 2015	18	16
Treasury stock, at cost - 247,566,270 shares as of June 30, 2016 and 247,566,270 shares as of December 31, 2015	(1,717)	(1,717)
Additional paid-in capital	16,923	16,860
Accumulated deficit	(8,934)	(8,927)
Accumulated other comprehensive income (loss), net of tax	(70)	88
Total stockholders’ equity	6,220	6,320
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$17,838	$18,133

See notes to the unaudited condensed consolidated financial statements.

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

	Six Months Ended June 30,	
in millions	2016	2015
Cash provided by (used for) operating activities	$537	$(137)
Investing activities:		
Purchases of property, plant and equipment	(138)	(92)
Proceeds from disposal of property, plant and equipment	29	—
Purchases of privately-held securities	(36)	(140)
Purchases of notes receivable	(5)	—
Payments for acquisitions of businesses, net of cash acquired	—	(63)
Payments for investments and acquisitions of certain technologies	—	(2)
Cash provided by (used for) investing activities	(150)	(297)
Financing activities:		
Payments on long-term borrowings	(250)	(1,000)
Proceeds from long-term borrowings, net of debt issuance costs	—	1,831
Payment of contingent consideration	(35)	(87)
Proceeds from borrowings on credit facilities	40	395
Payments on borrowings from credit facilities	(40)	(395)
Cash used to net share settle employee equity awards	(56)	(62)
Proceeds from issuances of shares of common stock	73	70
Cash provided by (used for) financing activities	(268)	752
Effect of foreign exchange rates on cash	—	(2)
Net increase (decrease) in cash and cash equivalents	119	316
Cash and cash equivalents at beginning of period	319	587
Cash and cash equivalents at end of period	$438	$903
Supplemental Information		
Stock-based compensation expense	$58	$53
Fair value of contingent consideration recorded in purchase accounting	—	31

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 month periods ended June 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. For further information, refer to the consolidated financial statements and footnotes thereto included in Item 8 of our most recent Annual Report on Form 10-K.

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, 2016. Those items requiring disclosure (unrecognized subsequent events) in the financial statements have been disclosed accordingly. Refer to Note B - Acquisitions and Strategic Investments, Note H - Income Taxes and Note I - Commitments and Contingencies for more information.

Pension Termination Charges

Following our 2006 acquisition of Guidant Corporation, we sponsored the Guidant Retirement Plan, a frozen noncontributory defined benefit plan covering a select group of current and former employees. The plan was partially frozen as of September 25, 1995 and completely frozen as of May 31, 2007. The plan was subsequently terminated effective December 1, 2014. During 2015, we finalized the termination process and settled the plan’s obligations, and as a result, we recorded pension termination charges of $8 million during the first half of 2015 and an additional $36 million during the third quarter of 2015 for a total of $44 million of pension termination charges in the year ended December 31, 2015. We do not expect to record any additional pension termination charges in 2016 related to the termination of the Guidant Retirement Plan.

NOTE B – ACQUISITIONS AND STRATEGIC INVESTMENTS

2016 Acquisitions

We did not close any material acquisitions during the first half of 2016.

On July 27, 2016, we acquired Cosman Medical, Inc. (Cosman), a privately held manufacturer of radiofrequency ablation systems, expanding our Neuromodulation portfolio and offering physicians treating patients with chronic pain a wider choice of non-opioid therapeutic options. We plan to begin the process of integrating Cosman into our Neuromodulation business during the second half of 2016.

2015 Acquisitions

Xlumena, Inc.

On April 2, 2015, we acquired Xlumena, Inc. (Xlumena), a medical device company that developed minimally invasive devices for Endoscopic Ultrasound (EUS) guided transluminal drainage of targeted areas within the gastrointestinal tract. The purchase agreement called for an up-front payment of $63 million, an additional payment of $13 million upon FDA clearance of the HOT AXIOS™ product, and further sales-based milestones based on sales achieved through 2018. We are in the process of integrating Xlumena into our Endoscopy business, and expect the integration to be substantially complete by the end of 2016.

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Purchase Price Allocation

We accounted for the acquisition of Xlumena 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 are as follows (in millions):

Cash, net of cash acquired	$63
Fair value of contingent consideration	31
	$94

The following summarizes the aggregate purchase price allocation for the 2015 acquisition as of June 30, 2015 (in millions):

Goodwill	$30
Amortizable intangible assets	68
Inventory	1
Other net assets	2
Deferred income taxes	(7)
	$94

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	$ 68	11	15 %
	$ 68		

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 re-measure this liability each reporting period and record changes in the fair value through a separate line item within our condensed consolidated statements of operations.

We recorded net expenses related to the changes in fair value of our contingent consideration liabilities of $33 million during the second quarter of 2016, $37 million during the first half of 2016, $19 million during the second quarter of 2015 and $46 million during the first half of 2015. We paid contingent consideration of $14 million during the second quarter of 2016, $77 million during the first half of 2016, $11 million during the second quarter of 2015 and $110 million during the first half of 2015.

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

Balance as of December 31, 2015	$246
Other amounts recorded related to prior acquisitions	1
Fair value adjustments	37
Contingent payments related to prior period acquisitions	(77)
Balance as of June 30, 2016	$207

As of June 30, 2016, the maximum amount of future contingent consideration (undiscounted) that we could be required to pay was approximately $1.572 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 liabilities include the following significant unobservable inputs:

Contingent Consideration Liabilities	Fair Value as of June 30, 2016	Valuation Technique	Unobservable Input	Range
R&D, regulatory and commercialization-based Milestones	$17 million	Discounted Cash Flow	Discount Rate	2.0% - 2.9%
			Probability of Payment	0% - 64%
			Projected Year of Payment	2018 - 2021
Revenue-based Payments	$41 million	Discounted Cash Flow	Discount Rate	14% - 15%
			Projected Year of Payment	2017 - 2020
	$149 million	Monte Carlo	Revenue Volatility	20%
			Risk Free Rate	LIBOR Term Structure & Cost of Debt Structure
			Projected Year of Payment	2016 - 2022

Increases or decreases in the fair value of our contingent consideration liabilities 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 R&D, regulatory commercialization-based and revenue-based milestones. Projected contingent payment amounts related to some of our R&D, regulatory and commercialization-based and 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 together, or in isolation, may result in a significantly lower or higher fair value measurement.

Strategic Investments

We did not close any material strategic investments during the first half of 2016.

On April 30, 2015, we acquired a 27 percent ownership interest in Preventice, Inc. (Preventice), which includes 18.5 percent of Preventice's common stock. Preventice is a privately-held company headquartered in Minneapolis, MN, and a leading developer of mobile health solutions and services. Preventice offers a full portfolio of wearable cardiac monitors, including Holter monitors, cardiac event monitors and mobile cardiac telemetry. In addition to the equity agreement, we entered into a commercial agreement with Preventice, under which we have become Preventice’s exclusive, worldwide sales and marketing representative. We believe this partnership strengthens our portfolio of cardiac monitoring and broader disease management capabilities.

On April 13, 2015, we acquired 25 percent of the common stock of Frankenman Medical Equipment Company (Frankenman). Frankenman is a privately-held company headquartered in Suzhou, China, and is a local market leader in surgical staplers. Additionally, we entered into co-promotional and co-selling agreements with Frankenman to jointly commercialize selected products in China. We believe this alliance will enable us to reach more clinicians and treat more patients in China by providing access to training on less invasive endoscopic technologies with clinical and economic benefits.

We account for certain of our strategic investments as equity method investments, in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 323, Investments - Equity Method and Joint Ventures. The book value of investments that we accounted for under the equity method of accounting was $221 million as of June 30, 2016 and $173 million as of December 31, 2015. The aggregate value of our cost method investments was $25 million as of June 30, 2016 and $45 million as of December 31, 2015. In addition we had notes receivable from certain companies that we account for under the cost method of $32 million as of June 30, 2016 and $30 million as of December 31, 2015.

As of June 30, 2016, the book value of our equity method investments exceeded our share of the book value of the investees' underlying net assets by approximately $140 million, which represents amortizable intangible assets and in-process research and development, corresponding deferred tax liabilities, and goodwill. During the three and six months ended June 30, 2016 and June 30, 2015, the net losses from our equity method adjustments, presented within the Other, net caption of our condensed consolidated statement of operations were immaterial.

NOTE C – 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, 2016 and December 31, 2015 are as follows:

	As of			
	June 30, 2016		December 31, 2015	
	Gross Carrying	Accumulated Amortization/	Gross Carrying	Accumulated Amortization/
(in millions)	Amount	Write-offs	Amount	Write-offs
Amortizable intangible assets				
Technology-related	$8,948	$ (4,257)	$8,948	$ (4,054)
Patents	522	(366)	520	(358)
Other intangible assets	1,531	(666)	1,529	(610)
	$11,001	$ (5,289)	$10,997	$ (5,022)
Unamortizable intangible assets				
Goodwill	$16,375	$ (9,900)	$16,373	$ (9,900)
In-process research and development (IPR&D)	98	—	99	—
Technology-related	120	—	120	—
	$16,593	$ (9,900)	$16,592	$ (9,900)

Our technology-related intangible assets that are not subject to amortization represent technical processes, intellectual property and/or institutional understanding acquired through business combinations that are fundamental to the on-going operations of our business and have no limit to their useful life. Our technology-related intangible assets that are not subject to amortization are comprised primarily of certain acquired balloon and other technology, which is foundational to our continuing operations within the Cardiovascular market and other markets within interventional medicine. We assess our indefinite-lived intangible assets at least annually for impairment and reassess their classification as indefinite-lived assets. We assess qualitative factors to determine whether the existence of events and circumstances indicate that it is more likely than not that our indefinite-lived intangible assets are impaired. If we conclude that it is more likely than not that the asset is impaired, we then determine the fair value of the intangible asset and perform the quantitative impairment test by comparing the fair value with the carrying value in accordance with ASC Topic 350, Intangibles - Goodwill and Other.

The following represents our goodwill balance by global reportable segment:

(in millions)	Cardiovascular	Rhythm Management	MedSurg	Total
Balance as of December 31, 2015	$ 3,451	$ 292	$ 2,730	$6,473
Purchase price adjustments	—	—	2	2
Balance as of June 30, 2016	$ 3,451	$ 292	$ 2,732	$6,475

Goodwill Impairment Testing

In the second quarter of 2016, we performed our annual goodwill impairment test for all of our reporting units and concluded the fair value of each reporting unit exceeded its carrying value. Based on the criteria prescribed in FASB ASC Topic 350 - Intangibles - Goodwill and Other, we assess goodwill for impairment at the reporting unit level, which is defined as an operating segment or one level below an operating segment, referred to as a component. In 2016 and 2015, we identified six operating segments including Interventional Cardiology, Peripheral Interventions, Rhythm Management, Endoscopy, Urology and Pelvic Health, and Neuromodulation. For purposes of identifying our reporting units, we then assessed whether any components of these segments constitute a business for which discrete financial information is available and where segment management regularly reviews the operating results of that component. We identified Rhythm Management as having two components: Cardiac Rhythm Management and Electrophysiology.

For our 2016 and 2015 annual impairment assessment, we identified seven reporting units, which align to our seven core businesses: Interventional Cardiology, Peripheral Interventions, Cardiac Rhythm Management, Electrophysiology, Endoscopy, Urology and

Pelvic Health, and Neuromodulation. For our 2016 annual impairment assessment the Cardiac Rhythm Management and Electrophysiology reporting units, components of the Rhythm Management operating segment, were aggregated due to a reorganization commencing in 2015 which resulted in integrated leadership, shared resources and consolidation of certain sites in 2016. Because our global Electrophysiology reporting unit was identified as being at higher risk of potential goodwill impairment during our 2015 annual test, it was tested for impairment on a stand-alone basis in the second quarter of 2016, immediately prior to aggregating it with our global Cardiac Rhythm Management reporting unit. The fair value exceeded the carrying value by approximately 36 percent. In comparison, the global Electrophysiology reporting unit had excess fair value of approximately 28 percent as of our 2015 annual test.

As of the date of our 2016 annual goodwill impairment test, the aggregated global Electrophysiology and Cardiac Rhythm Management reporting unit (Rhythm Management) had excess fair value over carrying value of approximately 70 percent and held $292 million of allocated goodwill. As such, it was not deemed at higher risk of future impairment. 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. Refer to Critical Accounting Policies and Estimates within our Management's 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. 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. 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.

Future events that could have a negative impact on the levels of excess fair value over carrying value of our reporting units 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;

- negative developments in intellectual property litigation that may impact our ability to market certain products or increase our costs to sell certain products;

- the level of success of ongoing and future research and development efforts, including those related to recent acquisitions, and increases in the research and development costs necessary to obtain regulatory approvals and launch new products;

- the level of success in managing the growth of acquired companies, achieving sustained profitability consistent with our expectations, establishing government and third-party payer reimbursement, supplying the market, and increases in the costs and time necessary to integrate acquired businesses into our operations successfully;
- 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; and
- increases in our market-participant risk-adjusted WACC, and increases in our market-participant tax rate, and/or changes in tax laws or macroeconomic conditions.

Negative changes in one or more of these factors, among others, could result in impairment charges.

The following is a rollforward of accumulated goodwill write-offs by global reportable segment:

(in millions)	Cardiovascular	Rhythm Management	MedSurg	Total
Accumulated write-offs as of December 31, 2015	$ (1,479)	$ (6,960)	$(1,461)	$(9,900)
Goodwill written off	—	—	—	—
Accumulated write-offs as of June 30, 2016	$ (1,479)	$ (6,960)	$(1,461)	$(9,900)

Intangible Asset Impairment Testing

On a quarterly basis, we monitor for events or other potential indicators of impairment that would warrant an interim impairment test of our intangible assets. We did not record any intangible asset impairment charges during the six months ended June 30, 2016.

2015 Charges

During the second quarter of 2015, in conjunction with our annual strategic planning process and annual goodwill impairment test, we performed an interim impairment test on certain of our IPR&D projects and core technology assets. Based on our impairment assessment, we recorded an impairment charge of $9 million in the second quarter of 2015.

The nonrecurring Level 3 fair value measurements of our intangible asset impairment analysis included the following significant unobservable inputs:

Intangible Asset	Valuation Date	Fair Value	Valuation Technique	Unobservable Input	Rate
In-Process R&D	June 30, 2015	$6 million	Income Approach - Excess Earnings Method	Discount Rate	16.5 - 20%

NOTE D – FAIR VALUE MEASUREMENTS

Derivative Instruments and Hedging Activities

We address market risk from changes in foreign currency exchange rates and interest rates through a risk management program that includes the use of derivative financial instruments, and we operate the program pursuant to documented corporate risk management policies. Our derivative instruments do not subject our earnings or cash flows to material risk, as gains and losses on these derivatives generally offset losses and gains on the item being hedged. We do not enter into derivative transactions for speculative purposes, and we do not have any non-derivative instruments that are designated as hedging instruments pursuant to FASB ASC Topic 815, Derivatives and Hedging (Topic 815).

Currency Hedging

We are exposed to currency risk consisting primarily of foreign currency denominated monetary assets and liabilities, forecasted foreign currency denominated intercompany and third-party transactions and net investments in certain subsidiaries. We manage our exposure to changes in foreign currency exchange rates on a consolidated basis to take advantage of offsetting transactions. We use derivative instruments and non-derivative transactions to reduce the risk that our earnings and cash flows associated with these foreign currency denominated balances and transactions will be adversely affected by foreign currency exchange rate changes.

Currently or Previously Designated Foreign Currency Hedges

All of our designated currency hedge contracts outstanding as of June 30, 2016 and December 31, 2015 were cash flow hedges under Topic 815 intended to protect the U.S. dollar value of our forecasted foreign currency denominated transactions. We record the effective portion of any change in the fair value of foreign currency cash flow hedges in other comprehensive income (OCI) until the related third-party transaction occurs. Once the related third-party transaction occurs, we reclassify the effective portion of any related gain or loss on the foreign currency cash flow hedge to earnings. In the event the hedged forecasted transaction does not occur, or it becomes no longer probable that it will occur, we reclassify the amount of any gain or loss on the related cash flow hedge to earnings at that time. We had currency derivative instruments designated as cash flow hedges outstanding in the contract amount of $2.476 billion as of June 30, 2016 and $1.458 billion as of December 31, 2015.

We recognized net gains of $32 million in earnings on our cash flow hedges during the second quarter of 2016 and $80 million for the first half of 2016, as compared to net gains of $53 million during the second quarter of 2015 and $102 million for the first half of 2015. All currency cash flow hedges outstanding as of June 30, 2016 mature within 60 months. As of June 30, 2016, $7 million of net loss, net of tax, was recorded in accumulated other comprehensive income (AOCI) to recognize the effective portion of the fair value of any currency derivative instruments that are, or previously were, designated as foreign currency cash flow hedges, as compared to net gains, net of tax, of $145 million as of December 31, 2015. As of June 30, 2016, $49 million of net gains, net of tax, may be reclassified to earnings within the next twelve months.

The success of our hedging program depends, in part, on forecasts of transaction activity in various currencies (primarily British pound sterling, Euro and Japanese yen). We may experience unanticipated currency exchange gains or losses to the extent that there are differences between forecasted and actual activity during periods of currency volatility. In addition, changes in foreign currency exchange rates related to any unhedged transactions may impact our earnings and cash flows.

Non-designated Foreign Currency Contracts

We use currency forward contracts as a part of our strategy to manage exposure related to foreign currency denominated monetary assets and liabilities. These currency forward contracts are not designated as cash flow, fair value or net investment hedges under Topic 815; are marked-to-market with changes in fair value recorded to earnings; and are entered into for periods consistent with currency transaction exposures, generally less than one year. We had currency derivative instruments not designated as hedges under Topic 815 outstanding in the contract amount of $2.389 billion as of June 30, 2016 and $2.090 billion as of December 31, 2015.

Interest Rate Hedging

Our interest rate risk relates primarily to U.S. dollar borrowings, partially offset by U.S. dollar cash investments. We have historically used interest rate derivative instruments to manage our earnings and cash flow exposure to changes in interest rates by converting floating-rate debt into fixed-rate debt or fixed-rate debt into floating-rate debt. We had no interest rate derivative instruments outstanding as of June 30, 2016.

We designate these derivative instruments either as fair value or cash flow hedges under Topic 815. We record changes in the value of fair value hedges in interest expense, which is generally offset by changes in the fair value of the hedged debt obligation. Interest payments made or received related to our interest rate derivative instruments are included in interest expense. We record the effective portion of any change in the fair value of derivative instruments designated as cash flow hedges as unrealized gains or losses in OCI, net of tax, until the hedged cash flow occurs, at which point the effective portion of any gain or loss is reclassified to earnings. We record the ineffective portion of our cash flow hedges in interest expense. In the event the hedged cash flow does not occur, or it becomes no longer probable that it will occur, we reclassify the amount of any gain or loss on the related cash flow hedge to interest expense at that time.

In the fourth quarter of 2013, we entered into interest rate derivative contracts having a notional amount of $450 million to convert fixed-rate debt into floating-rate debt, which we designated as fair value hedges. During the first quarter of 2015, we terminated these hedges, and we received total proceeds of approximately $35 million, which included approximately $7 million of net accrued interest receivable. We assessed at inception, and re-assessed on an ongoing basis, whether the interest rate derivative contracts were highly effective in offsetting changes in the fair value of the hedged fixed-rate debt. We recognized no gains or losses in interest expense, related to fair value hedges, during the second quarter of 2015. During the first half of 2015, we recognized, in interest expense, an $8 million loss on our hedged debt and an $8 million gain on the related interest rate derivative contract.

We are amortizing the gains and losses on previously terminated interest rate derivative instruments, including fixed-to-floating interest rate contracts designated as fair value hedges, and forward starting interest rate derivative contracts and treasury locks designated as cash flow hedges upon termination into earnings as a component of interest expense over the remaining term of the hedged debt, in accordance with Topic 815. The carrying amount of certain of our senior notes included unamortized gains of $57 million as of June 30, 2016 and $63 million as of December 31, 2015. We had immaterial unamortized losses as of June 30, 2016 and December 31, 2015 related to the fixed-to-floating interest rate contracts. In addition, we had pre-tax net gains within AOCI related to terminated forward starting interest rate derivative contracts and treasury locks of $9 million as of June 30, 2016 and $10 million as of December 31, 2015. The net gains that we recognized as a reduction of interest expense in earnings related to previously terminated interest rate derivatives were approximately $3 million during the second quarter of 2016 and $6 million during the first half of 2016, as compared to $5 million during the second quarter of 2015 and $7 million during the first half of 2015. As of June 30, 2016, $13 million of pre-tax net gains may be reclassified to earnings within the next twelve months as a reduction to interest expense from amortization of our terminated interest rate derivative contracts.

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Counterparty Credit Risk

We do not have significant concentrations of credit risk arising from our derivative financial instruments, whether from an individual counterparty or a related group of counterparties. We manage the concentration of counterparty credit risk on our derivative instruments by limiting acceptable counterparties to a diversified group of major financial institutions with investment grade credit ratings, limiting the amount of credit exposure to each counterparty, and actively monitoring their credit ratings and outstanding fair values on an ongoing basis. Furthermore, none of our derivative transactions are subject to collateral or other security arrangements, and none contain provisions that are dependent on our credit ratings from any credit rating agency.

We also employ master netting arrangements that reduce our counterparty payment settlement risk on any given maturity date to the net amount of any receipts or payments due between us and the counterparty financial institution. Thus, the maximum loss due to counterparty credit risk is limited to the unrealized gains in such contracts net of any unrealized losses should any of these counterparties fail to perform as contracted. Although these protections do not eliminate concentrations of credit risk, as a result of the above considerations, we do not consider the risk of counterparty default to be significant.

Fair Value of Derivative Instruments

The following presents the effect of our derivative instruments designated as cash flow hedges under Topic 815 on our accompanying unaudited condensed consolidated statements of operations during the second quarter and first half of 2016 and 2015 (in millions):

	Amount of Pre-tax Gain (Loss) Recognized in OCI (Effective Portion)	Amount of Pre-tax Gain (Loss) Reclassified from AOCI into Earnings (Effective Portion)	Location in Statement of Operations
Three Months Ended June 30, 2016			
Currency hedge contracts	$ (99)	$ 32	Cost of products sold
	$ (99)	$ 32	
Three Months Ended June 30, 2015			
Currency hedge contracts	$ (25)	$ 53	Cost of products sold
Interest rate derivative contracts	$ 10	$ 1	Interest Expense
	$ (15)	$ 54	
Six Months Ended June 30, 2016			
Currency hedge contracts	$ (158)	$ 80	Cost of products sold
	$ (158)	$ 80	
Six Months Ended June 30, 2015			
Currency hedge contracts	$ 68	$ 102	Cost of products sold
Interest rate derivative contracts	$ 11	$ 2	Interest Expense
	$ 79	$ 104	

The amount of gain (loss) recognized in earnings related to the ineffective portion of hedging relationships was immaterial for all periods presented.

Net gains and losses on currency hedge contracts not designated as hedging instruments were offset by net losses and gains from foreign currency transaction exposures, as shown in the following table:

in millions	Location in Statement of Operations	Three Months Ended		Six Months Ended	
		June 30,		June 30,	
		2016	2015	2016	2015
Gain (loss) on currency hedge contracts	Other, net	$(28)	$(9)	$(67)	$14
Gain (loss) on foreign currency transaction exposures	Other, net	29	4	63	(28)
Net foreign currency gain (loss)	Other, net	$1	$(5)	$(4)	$(14)

Topic 815 requires all derivative instruments to be recognized at their fair values as either assets or liabilities on the balance sheet. We determine the fair value of our derivative instruments using the framework prescribed by FASB ASC Topic 820, Fair Value Measurements and Disclosures (Topic 820), by considering the estimated amount we would receive or pay to transfer these instruments at the reporting date and by taking into account current interest rates, foreign currency exchange rates, the creditworthiness of the counterparty for the assets and our creditworthiness for liabilities. In certain instances, we may utilize financial models to measure fair value. In doing so, we use inputs that include quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; other observable inputs for the asset or liability; and inputs derived principally from, or corroborated by, observable market data by correlation or other means. As of June 30, 2016, we have classified all of our derivative assets and liabilities within Level 2 of the fair value hierarchy prescribed by Topic 820, as discussed below, because these observable inputs are available for substantially the full term of our derivative instruments.

The following are the balances of our derivative assets and liabilities as of June 30, 2016 and December 31, 2015:

		As of	
(in millions)	Location in Balance Sheet (1)	June 30, 2016	December 31, 2015
Derivative Assets:			
Currently or Previously Designated Hedging Instruments			
Currency hedge contracts	Other current assets	$88	$ 138
Currency hedge contracts	Other long-term assets	13	66
		101	204
Non-Designated Hedging Instruments			
Currency hedge contracts	Other current assets	43	33
Total Derivative Assets		$144	$ 237
Derivative Liabilities:			
Currently or Previously Designated Hedging Instruments			
Currency hedge contracts	Other current liabilities	$21	$ 1
Currency hedge contracts	Other long-term liabilities	99	—
		120	1
Non-Designated Hedging Instruments			
Currency hedge contracts	Other current liabilities	79	22
Total Derivative Liabilities		$199	$ 23

(1) We classify derivative assets and liabilities as current when the remaining term of the derivative contract is one year or less.

Other Fair Value Measurements

Recurring Fair Value Measurements

On a recurring basis, we measure certain financial assets and financial liabilities at fair value based upon quoted market prices, where available. Where quoted market prices or other observable inputs are not available, we apply valuation techniques to estimate fair value. Topic 820 establishes a three-level valuation hierarchy for disclosure of fair value measurements. The categorization of financial assets and financial liabilities within the valuation hierarchy is based upon the lowest level of input that is significant to the measurement of fair value. The three levels of the hierarchy are defined as follows:

- Level 1 – Inputs to the valuation methodology are quoted market prices for identical assets or liabilities.
- Level 2 – Inputs to the valuation methodology are other observable inputs, including quoted market prices for similar assets or liabilities and market-corroborated inputs.
- Level 3 – Inputs to the valuation methodology are unobservable inputs based on management’s best estimate of inputs market participants would use in pricing the asset or liability at the measurement date, including assumptions about risk.

Assets and liabilities measured at fair value on a recurring basis consist of the following as of June 30, 2016 and December 31, 2015: