CHIRON CORP
Form 10-Q
August 12, 2003

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

ý **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**

For the quarterly period ended June 30, 2003

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 Number: 0-12798

CHIRON CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**94-2754624**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
4560 Horton Street, Emeryville, California	**94608**
(Address of principal executive offices)	(Zip code)

(510) 655-8730
(Registrant's telephone number, including area code)

Not Applicable
(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 ý No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes ý No o

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

Title of Class	Outstanding at July 31, 2003
Common Stock, $0.01 par value	186,524,841

CHIRON CORPORATION
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Item 1. Financial Statements

CHIRON CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands, except share data)

	June 30, 2003	December 31, 2002
ASSETS		
Current assets:		
Cash and cash equivalents	$ 876,043	$ 247,950
Short-term investments in marketable debt securities	271,290	626,130
Total cash and short-term investments	1,147,333	874,080
Accounts receivable, net	289,380	278,625
Current portion of notes receivable	750	718
Inventories, net of reserves	196,005	146,005
Current net deferred income tax assets	40,734	38,450
Derivative financial instruments	12,201	12,006
Other current assets	55,478	35,838
Total current assets	1,741,881	1,385,722
Noncurrent investments in marketable debt securities	119,171	414,447
Property, plant, equipment and leasehold improvements, at cost:		
Land and buildings	176,070	168,144
Laboratory, production and office equipment	461,059	418,255
Leasehold improvements	102,234	93,463
Construction-in-progress	83,382	74,717
	822,745	754,579
Less accumulated depreciation and amortization	(418,841)	(381,021)
Property, plant, equipment and leasehold improvements, net	403,904	373,558
Purchased technologies, net	246,949	257,613
Goodwill	243,476	239,746
Other intangible assets, net	146,502	147,089
Investments in equity securities and affiliated companies	113,504	87,167
Noncurrent notes receivable	8,959	8,939
Noncurrent derivative financial instruments	11,504	9,007
Other noncurrent assets	41,201	37,056
	$ 3,077,051	$ 2,960,344

The accompanying Notes to Condensed Consolidated Financial Statements are integral to this statement.

CHIRON CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS (Continued)
(Unaudited)

(In thousands, except share data)

	June 30, 2003	December 31, 2002
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 67,211	$ 59,022
Accrued compensation and related expenses	50,016	59,498
Derivative financial instruments	182	
Short-term borrowings		71
Current portion of unearned revenue	45,712	26,610
Income taxes payable	1,073	21,883
Other current liabilities	119,067	131,552
Total current liabilities	283,261	298,636
Long-term debt	421,073	416,954
Noncurrent derivative financial instruments		253
Noncurrent net deferred income tax liabilities	46,867	45,743
Noncurrent unearned revenue	54,711	62,580
Other noncurrent liabilities	41,857	35,813
Minority interest	6,115	5,355
Total liabilities	853,884	865,334
Commitments and contingencies		
Put options		19,054
Stockholders' equity:		
Common stock	1,917	1,917
Additional paid-in capital	2,476,039	2,445,208
Deferred stock compensation	(11,560)	(11,349)
Accumulated deficit	(128,093)	(221,236)
Accumulated other comprehensive income	96,875	54,861
Treasury stock, at cost (5,437,000 shares at June 30, 2003 and 4,830,000 shares at December 31, 2002)	(212,011)	(193,445)
Total stockholders' equity	2,223,167	2,075,956
	$ 3,077,051	$ 2,960,344

The accompanying Notes to Condensed Consolidated Financial Statements are integral to this statement.

CHIRON CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(In thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Revenues:				
Product sales, net	$ 245,928	$ 211,293	$ 464,548	$ 384,877
Earnings of unconsolidated joint business	27,475	27,394	53,927	46,192
Collaborative agreement revenues	3,624	6,602	7,738	12,809
Royalty and license fee revenues	66,876	45,494	120,300	90,372
Other revenues	6,369	8,495	24,794	17,225
Total revenues	350,272	299,278	671,307	551,475
Operating expenses:				
Cost of sales	97,420	76,225	183,009	142,391
Research and development	89,915	83,530	172,045	162,303
Selling, general and administrative	79,707	71,093	152,749	133,863
Amortization expense	7,701	7,446	15,314	14,824
Write-off of purchased in-process research and development				54,781
Restructuring and reorganization charges	519		675	
Other operating expenses	1,259	899	2,794	5,482
Total operating expenses	276,521	239,193	526,586	513,644
Income from operations	73,751	60,085	144,721	37,831
Interest expense	(2,839)	(3,133)	(6,301)	(6,288)
Interest and other income, net	11,613	12,613	25,931	32,760
Minority interest	(581)	(464)	(981)	(883)
Income from continuing operations before income taxes	81,944	69,101	163,370	63,420
Provision for income taxes	20,485	18,657	40,842	31,913
Income from continuing operations	61,459	50,444	122,528	31,507
Gain on disposal of discontinued operations	538		1,964	
Net income	$ 61,997	$ 50,444	$ 124,492	$ 31,507
Basic earnings per share:				
Income from continuing operations	$ 0.33	$ 0.27	$ 0.66	$ 0.17
Net income	$ 0.33	$ 0.27	$ 0.67	$ 0.17
Diluted earnings per share:				
Income from continuing operations	$ 0.32	$ 0.26	$ 0.65	$ 0.16
Net income	$ 0.33	$ 0.26	$ 0.66	$ 0.16

	Three Months Ended June 30,		Six Months Ended June 30,	

The accompanying Notes to Condensed Consolidated Financial Statements are integral to this statement.

CHIRON CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(In thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Net income	$ 61,997	$ 50,444	$ 124,492	$ 31,507
Other comprehensive income (loss):				
Change in foreign currency translation adjustment during the period, net of tax provision of $7,294 for the three months ended June 30, 2002 and $6,449 for the six months ended June 30, 2002	35,823	61,668	45,118	55,233
Net unrealized derivative loss arising during the period, net of tax benefit of $72 for the three months ended June 30, 2002		(118)		
Unrealized gains (losses) from investments:				
Net unrealized holding gains (losses) arising during the period, net of tax (provision) benefit of ($1,541) and $651 for the three months ended June 30, 2003 and 2002, respectively, and ($1,284) and $3,532 for the six months ended June 30, 2003 and 2002, respectively	3,083	658	2,640	(5,623)
Reclassification adjustment for net gains included in net income, net of tax provision of $1,834 and $1,891 for the three months ended June 30, 2003 and 2002, respectively, and $3,626 and $3,587 for the six months ended June 30, 2003 and 2002, respectively	(2,940)	(3,065)	(5,744)	(5,802)
Net unrealized gains (losses) from investments	143	(2,407)	(3,104)	(11,425)
Other comprehensive income	35,966	59,143	42,014	43,808
Comprehensive income	$ 97,963	$ 109,587	$ 166,506	$ 75,315

The accompanying Notes to Condensed Consolidated Financial Statements are integral to this statement.

CHIRON CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

	Six Months Ended June 30,	
	2003	**2002**
Net cash provided by operating activities	$ 113,177	$ 82,566
Cash flows from investing activities:		
Purchases of investments in marketable debt securities	(277,514)	(320,675)
Proceeds from sales and maturities of investments in marketable debt securities	917,794	311,113
Capital expenditures	(52,371)	(54,323)
Proceeds from sales of assets		182
Purchases of equity securities and interests in affiliated companies	(36,889)	(3,093)
Proceeds from sale of equity securities and interests in affiliated companies	7,428	13,415
Cash paid for acquisitions, net of cash acquired	(1,180)	(55,284)
Other, net	(777)	(877)
Net cash provided by (used in) investing activities	556,491	(109,542)
Cash flows from financing activities:		
Net repayment of short-term borrowings	(71)	(308)
Repayment of debt	(95)	
Payments to acquire treasury stock	(68,079)	(45,116)
Proceeds from reissuance of treasury stock	24,526	18,027
Proceeds from put options	2,144	2,028
Net cash used in financing activities	(41,575)	(25,369)
Net increase (decrease) in cash and cash equivalents	628,093	(52,345)
Cash and cash equivalents at beginning of the period	247,950	320,673
Cash and cash equivalents at end of the period	$ 876,043	$ 268,328

The accompanying Notes to Condensed Consolidated Financial Statements are integral to this statement.

CHIRON CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2003

(Unaudited)

Note 1 The Company and Summary of Significant Accounting Policies

Basis of Presentation

The information presented in the condensed consolidated financial statements at June 30, 2003, and for the three and six months ended June 30, 2003 and 2002, is unaudited but includes all normal recurring adjustments, which Chiron Corporation believes to be necessary for fair presentation of the periods presented.

The condensed consolidated balance sheet amounts at December 31, 2002, have been derived from audited financial statements. Historically, Chiron's operating results have varied considerably from period to period due to the nature of Chiron's collaborative, royalty and license arrangements and the seasonality of certain vaccine products. In addition, the mix of products sold and the introduction of new products will affect comparability from quarter to quarter. As a consequence, Chiron's interim results in any one quarter are not necessarily indicative of results to be expected for a full year. This information should be read in conjunction with Chiron's audited consolidated financial statements for the year ended December 31, 2002, which are included in the Annual Report on Form 10-K filed by Chiron with the Securities and Exchange Commission.

Principles of Consolidation

The condensed consolidated financial statements include the accounts of Chiron and its majority-owned subsidiaries. For consolidated majority-owned subsidiaries in which Chiron owns less than 100%, Chiron records minority interest in the condensed consolidated financial statements to account for the ownership interest of the minority owner. Investments in joint ventures, limited partnerships and interests in which Chiron has an equity interest of 50% or less, are accounted for using either the equity or cost method based on Chiron's ownership levels and the ability of Chiron to exert significant influence over the entity's operating, investing and financing decisions. All significant intercompany accounts and transactions have been eliminated in consolidation.

On July 1, 2002, Chiron completed its acquisition of Pulmopharm GmbH, a distributor of TOBI® products in Germany and Austria by purchasing the remaining 80.1% ownership that Chiron did not previously own. Previously, Chiron owned 19.9% of Pulmopharm and accounted for the investment under the equity method. Chiron accounted for the acquisition using the purchase method of accounting and included Pulmopharm's operating results in its consolidated operating results beginning on July 1, 2002. Pulmopharm is part of Chiron's biopharmaceuticals segment (see Note 5).

On February 20, 2002, Chiron acquired Matrix Pharmaceutical, Inc., a company that was developing tezacitabine, a drug to treat cancer. Chiron included Matrix Pharmaceutical's operating results, including the seven business days from February 20 to 28, 2002, in its consolidated operating results beginning on March 1, 2002 (see Note 5).

Chiron is a limited partner of several venture capital funds. Chiron is obligated to pay $60.0 million over ten years in equity contributions to these venture capital funds, of which approximately $28.7 million was paid through June 30, 2003. Chiron accounts for these investments under the equity method of accounting.

Use of Estimates and Reclassifications

The preparation of financial statements requires management to make estimates, assumptions and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. On an on-going basis, management evaluates its estimates, including those related to investments; inventories; derivatives; intangible assets; purchased in-process research and development; product discounts, rebates and returns; bad debts; collaborative, royalty and license arrangements; restructuring; pension and other post-retirement benefits; income taxes; and litigation and other contingencies. Chiron bases its estimates on historical experience and on various other assumptions that are believed 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 from those estimates under different assumptions or conditions.

Chiron's blood testing segment consists of Chiron's one-half interest in the pretax operating earnings of its joint business contractual arrangement with Ortho-Clinical Diagnostics, Inc., a Johnson & Johnson company. Chiron's joint business arrangement with Ortho-Clinical Diagnostics is operated under a contractual arrangement and is not a separate and distinct legal entity. Through Chiron's joint business contractual arrangement with Ortho-Clinical Diagnostics, Chiron sells a line of immunodiagnostic tests to detect hepatitis viruses and retroviruses and provides supplemental tests and microplate and chemiluminescent instrument systems to automate test performance and data collection. Prior to the first quarter 2003, Chiron had accounted for revenues from non-U.S. affiliate sales on a one-quarter lag, with an adjustment of the estimate to actual in the subsequent quarter. More current information of non-U.S. affiliate sales of the joint business contractual arrangement became available in the first quarter 2003, and as a result, Chiron is able to recognize revenues from non-U.S. affiliate sales on a one-month lag. The effect of this change, net of tax, was an increase to net income by $3.2 million for earnings of unconsolidated joint business for the six months ended June 30, 2003.

Chiron recognizes a portion of revenue for product sales of Betaseron® upon shipment to its marketing partner, and the remainder based on a contractual percentage of sales by its marketing partner. Chiron also earns royalties on the marketing partner's European sales of Betaferon® in those cases where Chiron does not supply the product. Prior to the first quarter 2002, Chiron had accounted for revenues from non-U.S. product sales on a one-quarter lag and royalties as a percentage of forecast received from its marketing partner, with an adjustment of the estimate to actual in the subsequent quarter. More current information of non-U.S. Betaseron® sales became available in 2002, and as a result, Chiron is able to recognize revenues from Betaseron® product sales and Betaferon® royalties on a current basis. The effect of this change, net of tax, was a decrease in net loss for the first quarter 2002 and an increase in net income for the six months ended June 30, 2002 by $3.1 million for product sales and $2.8 million for royalties.

Revenue Recognition

Chiron's blood testing segment recognizes revenues related to nucleic acid testing product sales, which primarily consist of revenue derived from the sale and use of assays, revenue derived from the

sale, lease or rental of equipment and revenue from providing field service for the instruments. In the case of assay sales and equipment rentals included as part of the assay contract (commonly referred to as "reagent rental" agreements), revenue is recorded based upon the reported results obtained from the customer for the use of assays to screen donations or upon sale and delivery of the assays depending on the underlying contract. In the case of equipment sales or leases, revenue is recorded upon the sale and transfer of the title to the instrument or ratably over the life of the lease term. For the provision of service on the instruments, revenue is recognized ratably over the life of the service agreement term.

Inventories

Inventories are stated at the lower of cost or market using the moving weighted-average cost method. Inventory that is obsolete (inventory that will no longer be used in the manufacturing process), expired, or in excess of forecasted usage is written down to its market value. Inventories, net of reserves consisted of the following (in thousands):

	June 30, 2003	December 31, 2002
Finished goods	$ 49,881	$ 32,697
Work-in-process	99,306	77,232
Raw materials	46,818	36,076
	$ 196,005	$ 146,005

Income Taxes

The reported effective tax rate for 2003 is 25% of pretax income from operations. The effective tax rate may be affected in future periods by changes in Chiron's estimates with respect to the deferred tax assets, acquisitions and other items affecting the overall tax rate. Income tax expense for the six months ended June 30, 2002, was based on an estimated annual effective tax rate on pretax income from continuing operations of approximately 27%, excluding the write-off of purchased in-process research and development related to the acquisition of Matrix Pharmaceutical, Inc. (see Note 5).

Put Options

Chiron has used written put options to reduce the effective costs of repurchasing its common stock. The put option contracts provide that Chiron, at its choice, can settle with cash or through physical delivery of shares and, accordingly, the fair value of such put option contracts (premiums received) is initially classified in equity. However, because either settlement choice could require Chiron to deliver cash if the put option is exercised, an amount equal to the cash redemption value of the put option contracts is classified as temporary equity until expiration of the option.

Stock-Based Compensation

Chiron measures compensation expense for its stock-based employee compensation plans using the intrinsic method prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" and related Interpretations, including Financial Accounting Standards Board, referred to as FASB, Interpretation No. 44 "Accounting for Certain Transactions Involving Stock Compensation." Compensation expense is based on the difference, if any, between the fair value of Chiron's common stock and the exercise price of the option or share right on the measurement date, which is typically the date of grant. This amount is recorded as "Deferred stock compensation" in the Condensed Consolidated Balance Sheets and amortized as a charge to operations over the vesting period of the applicable options or share rights. Compensation expense is included primarily in "Selling, general and administrative" in the Condensed Consolidated Statements of Operations.

In accordance with Statement of Financial Accounting Standards, referred to as SFAS, No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation Transition and Disclosure," Chiron has provided, below, the pro forma disclosures of the effect on net income and net income per share as if SFAS No. 123 had been applied in measuring compensation expense for all periods presented. Due to rounding, quarterly amounts may not sum fully to yearly amounts.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
	(in thousands, except per share data)			
Net income:				
As reported	$ 61,997	$ 50,444	$ 124,492	$ 31,507
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	1,750	675	2,651	1,510
Less: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	19,933	15,462	38,045	29,729
Pro forma	$ 43,814	$ 35,657	$ 89,098	$ 3,288
Basic net income per share:				
As reported	$ 0.33	$ 0.27	$ 0.67	$ 0.17
Pro forma	$ 0.24	$ 0.19	$ 0.48	$ 0.02
Diluted net income per share:				
As reported	$ 0.33	$ 0.26	$ 0.66	$ 0.16
Pro forma	$ 0.23	$ 0.18	$ 0.47	$ 0.02

Comprehensive Income

In 2003, the foreign currency translation component of comprehensive income was not adjusted for income taxes, as it relates to permanent investments in non-U.S. subsidiaries. In 2002, the foreign currency translation component of comprehensive income included the tax effects of certain profit repatriations from Chiron's German and Italian vaccines subsidiaries. Additionally in 2002, all other foreign profits, net of the German and Italian profit repatriations, were considered permanently reinvested.

Treasury Stock

Treasury stock is stated at cost. Gains on reissuance of treasury stock are credited to "Additional paid-in capital." Losses on reissuance of treasury stock are charged to "Additional paid-in capital" to the extent of available net gains on reissuance of treasury stock. Otherwise, losses are charged to "Accumulated deficit." Chiron charged losses of $16.3 million and $23.8 million for the three and six months ended June 30, 2003, respectively, and $5.4 million and $22.9 million for the three and six months ended June 30, 2002, respectively, to "Accumulated deficit" in the Condensed Consolidated Balance Sheets.

New Accounting Standards

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." This Statement establishes new standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). This Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS No. 150 is not expected to have a material impact on the Consolidated Financial Statements.

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," which amends and clarifies the accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133. It requires, among other things, that contracts with comparable characteristics be accounted for similarly and clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative and when a derivative contains a financing component that warrants special reporting in the statement of cash flows. SFAS No. 149 is effective generally for contracts entered into and modified after June 30, 2003. The adoption of SFAS No. 149 is not expected to have a material impact on the Consolidated Financial Statements.

In January 2003, the FASB issued Interpretation No. 46 (referred to as FIN No. 46), "Consolidation of Variable Interest Entities" which address the accounting for certain off-balance sheet lease financing. The recognition provisions of FIN No. 46 will be effective for Chiron for the interim period ended September 30, 2003. The adoption of FIN No. 46 is not expected to have a material impact on the Consolidated Financial Statements.

In November 2002, the FASB issued EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables." EITF Issue No. 00-21 addresses certain aspects of the accounting by a company for arrangements under which it will perform multiple revenue-generating activities. EITF Issue No. 00-21 addresses when and how an arrangement involving multiple deliverables should be divided into separate units of accounting. EITF Issue No. 00-21 provides guidance with respect to the effect of certain customer rights due to company nonperformance on the recognition of revenue allocated to delivered units of accounting. EITF Issue No. 00-21 also addresses the impact on the measurement and/or allocation of arrangement consideration of customer cancellation provisions and consideration that varies as a result of future actions of the customer or the company. Finally, EITF Issue No. 00-21 provides guidance with respect to the recognition of the cost of certain deliverables that are excluded from the revenue accounting for an arrangement. The provisions of EITF Issue No. 00-21 apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The adoption of EITF Issue No. 00-21 is not expected to have a material impact on the Consolidated Financial Statements.

Note 2 Earnings Per Share

Basic earnings per share is based upon the weighted-average number of common shares outstanding. Diluted earnings per share is based upon the weighted-average number of common shares and dilutive potential common shares outstanding. Dilutive potential common shares could result from (i) the assumed exercise of outstanding stock options, warrants and equivalents, which are included under the treasury-stock method; (ii) performance units to the extent that dilutive shares are assumed issuable; (iii) the assumed exercise of outstanding put options, which are included under the reverse treasury-stock method; and (iv) convertible notes and debentures, which are included under the

if-converted method. Due to rounding, quarterly amounts may not sum fully to yearly amounts.

The following table sets forth the computations for basic and diluted earnings per share on income from continuing operations (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Income (Numerator):				
Income from continuing operations	$ 61,459	$ 50,444	$ 122,528	$ 31,507
Shares (Denominator):				
Weighted-average common shares outstanding	186,408	189,579	186,584	189,536
Effect of dilutive securities:				
Stock options and equivalents	3,550	3,346	3,294	3,668
Put options	5		3	5
Weighted-average common shares outstanding, plus assumed issuances	189,963	192,925	189,881	193,209
Basic earnings per share	$ 0.33	$ 0.27	$ 0.66	$ 0.17
Diluted earnings per share	$ 0.32	$ 0.26	$ 0.65	$ 0.16

The following table sets forth the computations for basic and diluted earnings per share on net income (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Income (Numerator):				
Net income	$ 61,997	$ 50,444	$ 124,492	$ 31,507
Shares (Denominator):				
Weighted-average common shares outstanding	186,408	189,579	186,584	189,536
Effect of dilutive securities:				
Stock options and equivalents	3,550	3,346	3,294	3,668
Put options	5		3	5
Weighted-average common shares outstanding, plus assumed issuances	189,963	192,925	189,881	193,209
Basic earnings per share	$ 0.33	$ 0.27	$ 0.67	$ 0.17
Diluted earnings per share	$ 0.33	$ 0.26	$ 0.66	$ 0.16

For the three months ended June 30, 2003 and 2002, stock options to purchase 16.8 million and 14.1 million shares, respectively, and for the six months ended June 30, 2003 and 2002, stock options to purchase 17.1 million and 13.8 million, respectively, with exercise prices greater than the average market prices of common stock, were excluded from the respective computations of diluted earnings per share as their inclusion would be antidilutive.

Also excluded from the computations of diluted earnings per share for each of the three and six months ended June 30, 2003 and June 30, 2002 were 5.2 million shares of common stock issuable upon conversion of the Liquid Yield Option Notes, as their inclusion would be antidilutive.

Note 3 Put Options

In May 2003, Chiron entered into a contract with a third party to sell put options on Chiron stock, entitling the holder to sell to Chiron 0.5 million shares at $43.89 per share. The option expired June 30, 2003. On June 30, 2003, Chiron's closing stock price was $43.86. The third party elected to exercise a portion of the options. As a result, Chiron repurchased 0.2 million shares.

In February 2003, Chiron entered into a contract with a third party to sell put options on Chiron stock, entitling the holder to sell to Chiron 0.5 million shares at $36.79 per share. The option expired unexercised on May 5, 2003.

As of December 31, 2002, Chiron had an outstanding put option contract with a third party entitling the holder to sell to Chiron 0.5 million shares at $38.11 per share. The option expired unexercised on January 29, 2003. This put option contract was initially classified as equity. However, because the settlement options available to Chiron could require Chiron to deliver cash if the put option was exercised by the counter-party, the cash redemption value, totaling $19.1 million, was reclassified from "Additional paid-in capital" to "Put options" in temporary equity in the Condensed Consolidated Balance Sheet at December 31, 2002. Upon expiration, the options were not exercised and the temporary equity of $19.1 million was reclassified to permanent equity in the first quarter 2003.

Note 4 Discontinued Operations

In a strategic effort to focus on its core businesses of biopharmaceuticals, vaccines and blood testing, Chiron completed the sale of Chiron Diagnostics and Chiron Vision in 1998 and 1997, respectively. Discontinued operations had no impact on basic earnings per share for the three months ended June 30, 2003. Diluted earnings per share from discontinued operations was $0.01 for the three months ended June 30, 2003. Basic and diluted earnings per share from discontinued operations were $0.01 for the six months ended June 30, 2003. There was no activity related to discontinued operations during the three and six months ended June 30, 2002.

In the second quarter 2003, Chiron reversed approximately $0.5 million related to unutilized reserves for Chiron Diagnostics and Chiron Vision, which was recorded as a "Gain on disposal of discontinued operations" for the three months ended June 30, 2003.

In the first quarter 2003, Chiron and Bayer Corporation reached a settlement agreement relating to certain claims raised by Bayer under the Stock Purchase Agreement dated September 17, 1998, between Chiron and Bayer for Chiron Diagnostics. Under this settlement agreement, Chiron was required to make a payment to Bayer during the first quarter 2003. Chiron utilized an amount previously reserved for indemnity obligations, based upon the settlement agreement with Bayer. These amounts resulted in a net charge of $7.6 million, offset by an income tax benefit of $9.0 million, resulting in a net gain of $1.4 million which was recorded as a "Gain on disposal of discontinued operations" for the six months ended June 30, 2003.

Income Taxes

In connection with the sale of Chiron Diagnostics and Chiron Vision, Chiron recorded cumulative net deferred tax assets of $0.2 million and $8.5 million at June 30, 2003 and December 31, 2002, respectively, principally attributable to the timing of the deduction of certain expenses associated with these sales. Chiron also recorded corresponding valuation allowances of $0.2 million and $8.5 million at June 30, 2003 and December 31, 2002, respectively, to offset these deferred tax assets, as management believes that it is more likely than not that the deferred tax assets to which the valuation allowance relates will not be realized. The future recognition of these deferred tax assets will be reported as a component of "Gain (loss) on disposal of discontinued operations."

Note 5 Acquisitions

Pulmopharm GmbH On July 1, 2002, Chiron completed its acquisition of Pulmopharm GmbH, a distributor of TOBI® products in Germany and Austria by purchasing the remaining 80.1% ownership that Chiron did not previously own. Previously, Chiron owned 19.9% of Pulmopharm and accounted for the investment under the equity method. Chiron's acquisition of all of the remaining outstanding shares of common stock of Pulmopharm, including estimated acquisition costs, resulted in a total purchase price of approximately $3.7 million. The acquisition resulted in the recognition of $3.8 million of intangible assets relating to the distribution rights, $1.2 million of goodwill, $0.3 million of tangible assets and $1.6 million of deferred tax liabilities on the acquisition date. In addition, on the acquisition date, the carrying value of the original investment in Pulmopharm, which totaled $0.3 million, was reclassified to goodwill. Chiron accounted for the acquisition using the purchase method of accounting and included Pulmopharm's operating results in its consolidated operating results beginning on July 1, 2002. Pulmopharm is part of Chiron's biopharmaceuticals segment.

Matrix Pharmaceutical, Inc. On February 20, 2002, Chiron acquired Matrix Pharmaceutical, Inc., a company that was developing tezacitabine, a drug to treat cancer. Chiron acquired all of the outstanding shares of common stock of Matrix Pharmaceutical at $2.21 per share, which, including acquisition costs, resulted in a total purchase price of approximately $67.0 million. Matrix Pharmaceutical is part of Chiron's biopharmaceuticals segment. Tezacitabine expanded Chiron's portfolio of cancer therapeutics.

Chiron accounted for the acquisition as an asset purchase and included Matrix Pharmaceutical's operating results, including the seven business days from February 20 to 28, 2002, in its consolidated operating results beginning on March 1, 2002. The components and allocation of the purchase price, based on their fair values, consisted of the following (in thousands):

Consideration and acquisition costs:		
Cash paid for common stock	$	58,737
Cash paid for options on common stock		2,231
Acquisition costs		6,078
Total purchase price	$	67,046

Allocation of purchase price:		
Cash and cash equivalents	$	17,337
Assets held for sale		2,300
Deferred tax assets		10,000
Other assets		1,469
Write-off of purchased in-process research and development		45,181
Accounts payable		(2,898)
Reduction of income taxes payable		1,739
Accrued liabilities		(8,082)
Total purchase price	$	67,046

Acquisition costs included contractual severance and involuntary termination costs, as well as other direct acquisition costs. Approximately $5.1 million represented severance payments, assumed by Chiron, to eligible employees as defined by their employment agreements.

Chiron allocated the purchase price based on the fair value of the assets acquired and liabilities assumed. Once value was allocated to tangible assets, the residual amount (which was less than the estimated fair value of the in-process research and development discussed below) was allocated to the identifiable intangible assets, including in-process research and development. Chiron allocated a portion of the purchase price to purchased in-process research and development and wrote off $54.8 million in the first quarter 2002. Chiron allocated a portion of the purchase price to a liability for asset disposal and lease cancellation for the San Diego, California facility closed during the third quarter 2002. In the fourth quarter 2002, Chiron found an assignee for the manufacturing facility lease and revised the allocation of the purchase price resulting

in a $9.6 million decrease to the liabilities relating to the expected exit of the facility. As a result, the revised aggregate fair value of the assets acquired and liabilities assumed, including purchased in-process research and development, exceeded the purchase price by $9.6 million. Accordingly, this excess credit of $9.6 million was allocated to purchased in-process research and development, as an excess credit allocated to any other acquired asset would have resulted in the recording of assets below fair value and would have required a gain to be recognized as current assets were realized. Chiron does not anticipate that there will be any alternative future use for the in-process research and development that was written off. The write-off of purchased in-process research and development represented the fair value, calculated using probability-of-success-adjusted cash flows and a 20% discount rate, at the acquisition date. Chiron assumed cash flows from tezacitabine to commence after 2005. As with all pharmaceutical products, the probability of commercial success for any research and development project is highly uncertain.

As indicated in the above table, a portion of the purchase price was allocated to assets held for sale. In March 2002, Chiron sold the leasehold improvements and assigned the lease related to a facility located in Fremont, California. Chiron received an amount equivalent to the fair value of the assets at the date of acquisition.

Chiron paid $1.0 million and $0.2 million related to severance payments included in acquisition costs for PathoGenesis Corporation and Matrix Pharmaceutical, respectively, for the six months ended June 30, 2003. These payments are reflected in the Condensed Consolidated Statement of Cash Flows

as a component of "Cash paid for acquisitions, net of cash acquired" for the six months ended June 30, 2003.

In March 2002, Chiron paid $6.0 million related to a bank loan assumed during the purchase of Matrix Pharmaceutical. This payment is reflected on the Condensed Consolidated Statement of Cash Flows as a component of "Cash paid for acquisitions, net of cash acquired" for the six months ended June 30, 2002.

The deferred tax assets primarily related to future utilization of net operating loss carryforwards. Chiron acquired federal and state net operating loss carryforwards and business credits attributed to Matrix Pharmaceutical of approximately $288.7 million and $9.5 million, respectively. The available utilization of such net operating loss and business tax credit carryforwards is limited in any one year to approximately $2.8 million per annum over the next twenty years under provisions of the Internal Revenue Code. As such, a significant portion of Matrix Pharmaceutical's net operating loss carryforwards is expected to expire unutilized.

Note 6 Restructuring and Reorganization

For the six months ended June 30, 2003, Chiron recorded restructuring and reorganization charges of $0.7 million. The charges, included in "Restructuring and reorganization charges" in the condensed consolidated statement of operations, consisted of termination and other employee-related costs recognized in connection with the elimination of 7 positions in its Amsterdam manufacturing facility. Termination notice has been provided. However, of the 7 positions for elimination, none were terminated as of June 30, 2003. For the six months ended June 30, 2002, Chiron had no restructuring and reorganization adjustments.

Previously, Chiron recorded restructuring and reorganization charges related to (i) the integration of its worldwide vaccines operations, (ii) the closure of its Puerto Rico and St. Louis, Missouri facilities and (iii) the ongoing restructuring of its business operations. The integration of its worldwide vaccines operations consisted of termination and other employee-related costs recognized in connection with the elimination of 28 positions, all of which had terminated as of December 31, 2000, in Chiron's Italian manufacturing facility and facility-related costs. The closure of its Puerto Rico and St. Louis facilities and the ongoing restructuring of its business operations consisted of termination and other employee-related costs recognized in connection with the elimination of 371 positions in manufacturing, research, development, sales, marketing and other administrative functions, and facility-related costs. Employee termination costs included wage continuation, advance notice pay and medical and other benefits. Facility-related costs included losses on disposal of property, plant and equipment, lease payments and other related costs. For the six months ended June 30, 2003 and 2002, Chiron had no restructuring and reorganization adjustments related to these items. Of the 371 positions for elimination, 366 were terminated as of June 30, 2003 and 363 had been terminated as of June 30, 2002.

Chiron expects to substantially settle the restructuring and reorganization accruals within one to six years of accruing the related charges. As of June 30, 2003, $0.9 million was included in "Other current liabilities" in the Condensed Consolidated Balance Sheet. As of December 31, 2002, $0.2 million and $0.1 million were included in "Other current liabilities" and "Other noncurrent liabilities," respectively, in the Condensed Consolidated Balance Sheet.

The activity in accrued restructuring and reorganization for the six months ended June 30, 2003 and 2002 is summarized as follows (in thousands):

	Accrual at December 31, 2002	Amount of Total Restructuring Charge	Amount Utilized Through June 30, 2003	Amount to Be Utilized In Future Periods
Employee-related costs and Other facility-related costs	$ 334	$ 675	$ (150)	$ 859

	Accrual at December 31, 2001	Amount of Total Restructuring Charge	Amount Utilized Through June 30, 2002	Amount to Be Utilized In Future Periods
Employee-related costs and Other facility-related costs	$ 693	$	$ (201)	$ 492

Note 7 Intangible Assets

In July 2001, the FASB issued SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." Chiron adopted the provisions of SFAS No. 141 immediately, and SFAS No. 142 effective January 1, 2002.

Intangible assets subject to amortization consisted of the following (in thousands):

	June 30, 2003			December 31, 2002		
	Gross Carrying Value	Accumulated Amortization	Net Carrying Value	Gross Carrying Value	Accumulated Amortization	Net Carrying Value
Purchased technologies	$ 331,975	$ 85,026	$ 246,949	$ 331,941	$ 74,328	$ 257,613
Patents	$ 112,711	$ 56,915	$ 55,796	$ 106,723	$ 52,136	$ 54,587
Trademarks	56,966	17,547	39,419	53,394	14,928	38,466
Licenses and technology rights	37,202	19,927	17,275	35,243	16,063	19,180
Customer relationships	26,298	8,392	17,906	24,082	7,054	17,028
Know how(1)	11,943	5,066	6,877	10,935	4,245	6,690
Databases	7,100	1,301	5,799	7,100	1,065	6,035
Other	15,356	11,926	3,430	15,274	10,171	5,103
Total other intangible assets	$ 267,576	$ 121,074	$ 146,502	$ 252,751	$ 105,662	$ 147,089
Total intangible assets subject to amortization	$ 599,551	$ 206,100	$ 393,451	$ 584,692	$ 179,990	$ 404,702

(1) Upon acquisition of a 100% interest in Chiron Behring by the second quarter 1998, Chiron acquired a portfolio of products that were created by Behring and are currently being sold internationally. These products embody Chiron Behring's proprietary "know-how" consisting of unpatented technology and trade secrets. Since the unpatented technology and trade secrets meet the separability criterion, Chiron has recognized them collectively as a separate intangible asset apart from goodwill in accordance with SFAS No. 141.

Aggregate amortization expense is as follows (in thousands):

For the six months ended June 30, 2003 (reported)	$ 27,399
For the remaining six months in the year ended December 31, 2003 (estimated)	27,461
For the year ended December 31, 2003 (estimated)	$ 54,860
For the year ended December 31, 2004 (estimated)	$ 51,909
For the year ended December 31, 2005 (estimated)	$ 47,467
For the year ended December 31, 2006 (estimated)	$ 45,862
For the year ended December 31, 2007 (estimated)	$ 44,662
For the year ended December 31, 2008 (estimated)	$ 43,846

The changes in the carrying value of goodwill by reporting unit consisted of the following (in thousands):

	Biopharmaceuticals	Vaccines	Total
Goodwill (including assembled workforce):			
Balance as of December 31, 2002	$ 199,225	$ 40,521	$ 239,746
Effect of exchange rate changes		3,730	3,730
Balance as of June 30, 2003	$ 199,225	$ 44,251	$ 243,476

Note 8 Segment Information

Chiron is organized based on the products and services that it offers. Under this organizational structure, there are three reportable segments: (i) biopharmaceuticals, (ii) vaccines and (iii) blood testing. The biopharmaceuticals segment consists of therapeutic products and services, with an emphasis on the treatment of cancer and infectious diseases, using the development and acquisition of technologies related to therapeutic proteins and small molecules. The vaccines segment consists principally of adult and pediatric vaccines for viral and bacterial infections. Chiron sells these vaccines primarily in Germany, Italy, the United Kingdom, and other international markets. The vaccines segment is also involved in the development of novel vaccines and vaccination technology. The blood testing segment consists of an alliance with Gen-Probe Incorporated and Chiron's one-half interest in the pretax operating earnings of its joint business contractual arrangement with Ortho-Clinical Diagnostics, Inc., a Johnson & Johnson company. Chiron's alliance with Gen-Probe is focused on developing and commercializing nucleic acid testing products using Transcription-Mediated Amplification technology to screen donated blood and plasma products for viral infection. Chiron's joint business arrangement with Ortho-Clinical Diagnostics is operated under a contractual arrangement and is not a separate and distinct legal entity. Through Chiron's joint business contractual arrangement with Ortho-Clinical Diagnostics, Chiron sells a line of immunodiagnostic tests to detect hepatitis viruses and retroviruses and provides supplemental tests and microplate and chemiluminescent instrument systems to automate test performance and data collection.

Revenues and expenses associated with Chiron's research and development activities specifically benefit each of the reportable segments and as such, have been included in the results of operations of the respective reportable segment.

Chiron views certain other revenues and expenses, particularly certain royalty and license fee revenues primarily related to HIV and hepatitis C virus related patents, and unallocated corporate expenses, as not belonging to any one reportable segment. As a result, Chiron has aggregated these items into an "Other" segment.

For the three and six months ended June 30, 2002, expenses of approximately $2.5 million and $4.4 million, respectively, previously allocated to the biopharmaceuticals segment, have been allocated to the vaccines segment to conform with the current period presentation.

The accounting policies of Chiron's reportable segments are the same as those described in Note 1 The Company and Summary of Significant Accounting Policies above and in Chiron's Annual Report on Form 10-K for the year ended December 31, 2002. Chiron evaluates the performance of its segments based on each segment's income (loss) from continuing operations, excluding certain special items, such as restructuring and reorganization charges and the write-off of purchased in-process research and development, which are shown as reconciling items in the table below.

The following segment information excludes all significant intersegment transactions as these transactions are eliminated for management reporting purposes (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Revenues				
Biopharmaceuticals:				
Product sales, net	$ 107,267	$ 104,065	$ 208,952	$ 194,501
Collaborative agreement revenues	1,118	3,428	3,282	7,015
Royalty and license fee revenues	20,758	16,424	38,574	33,737
Other revenues	3,151	1,907	18,785	6,644
Total biopharmaceuticals revenues	$ 132,294	$ 125,824	$ 269,593	$ 241,897
Vaccines:				
Product sales, net	$ 85,557	$ 72,602	$ 153,961	$ 130,600
Collaborative agreement revenues	166	333	167	333
Royalty and license fee revenues	3,343	2,791	6,529	5,434
Other revenues	3,218	5,218	6,009	9,098
Total vaccines revenues	$ 92,284	$ 80,944	$ 166,666	$ 145,465
Blood testing:				
Product sales, net	$ 53,104	$ 34,626	$ 101,635	$ 59,776
Earnings of unconsolidated joint business	27,475	27,394	53,927	46,192
Collaborative agreement revenues	2,340	2,841	4,289	5,461
Royalty and license fee revenues	23,160	12,573	38,796	22,762
Other revenues		41		41
Total blood testing revenues	$ 106,079	$ 77,475	$ 198,647	$ 134,232
Other:				
Royalty and license fee revenues	$ 19,615	$ 13,706	$ 36,401	$ 28,439
Other revenues		1,329		1,442

	Three Months Ended June 30,		Six Months Ended June 30,	
Total other revenues	$ 19,615	$ 15,035	$ 36,401	$ 29,881
Total revenues	$ 350,272	$ 299,278	$ 671,307	$ 551,475

Income (loss) from continuing operations				
Biopharmaceuticals	$ 8,872	$ 4,745	$ 33,971	$ 12,979
Vaccines	794	13,281	(4,508)	8,978
Blood testing	62,441	43,630	113,003	73,113
Other	2,163	(1,571)	2,930	(2,458)
Segment income from operations	74,270	60,085	145,396	92,612
Operating expense reconciling items:				
Write-off of purchased in-process research and development				(54,781)
Restructuring and reorganization charges	(519)		(675)	
Income from operations	73,751	60,085	144,721	37,831
Interest expense	(2,839)	(3,133)	(6,301)	(6,288)
Interest and other income, net	11,613	12,613	25,931	32,760
Minority interest	(581)	(464)	(981)	(883)
Income from continuing operations before income taxes	$ 81,944	$ 69,101	$ 163,370	$ 63,420

Note 9 Commitments and Contingencies

Effective June 2003, Chiron and SynCo Bio Partners B.V., a related party, executed a seven and a half-year contract manufacturing agreement. Under this agreement, SynCo agreed to provide services related to the production of certain of Chiron's vaccine products for the European and U.S. markets. Chiron has a firm binding order for products to be delivered by SynCo in 2004, 2005 and 2006 under this agreement. Chiron's minimum purchase obligation under this agreement, subject to adjustment depending on the quantities purchased by Chiron in years 2007 through 2010, inflation and movement in the Euro to U.S. Dollar exchange rate, is expected to be approximately $34.0 million over the term of the agreement.

Simultaneously in June 2003, Chiron and SynCo Bio Partners B.V. executed an FDA compliance agreement. Under this agreement, Chiron will fund certain costs required to bring SynCo's Amsterdam manufacturing facility into compliance to support approval by the U.S. Food and Drug Administration to manufacture certain vaccine products for the U.S. market. Chiron's funding commitment under this agreement is expected to be approximately $10.0 million through the first quarter 2005.

In July 2003, Chiron entered into a new six-year lease to rent a research and development facility in Emeryville, California following the expiration of the existing lease. Effective July 1, 2003, Chiron accounted for this new lease as a capital lease and, as a result, recorded the leased facility and the corresponding liability on its balance sheet. The amount recorded on the balance sheet for the leased facility is $157.5 million. At the inception of the lease, the future minimum lease payments, exclusive of a residual value guarantee, are approximately $15.7 million over the lease term. The interest payments

represent variable-rate interest payments indexed to a three-month London interbank offered rate plus 40 basis points. The lease provides a $156.0 million residual value guarantee from Chiron to the lessors in the event of property value declines. Consequently, Chiron's maximum payment obligation is $156.0 million upon termination of the lease on or before July 1, 2009. On or before July 1, 2009, Chiron can choose to either purchase the facility from the lessors or sell the facility to a third party. This option accelerates if Chiron defaults on its lease payments or in the event of other defined events. As of July 1, 2003, Novartis AG had guaranteed (under provisions of the Investment Agreement) payments on this lease commitment, including payment of the residual value guarantee, to a maximum of $173.3 million.

Chiron is limited partner of several venture capital funds, as discussed in Note 1 "The Company and Summary of Significant Accounting Policies." In the second quarter 2003, Chiron became a limited partner of two additional venture capital funds. Chiron is obligated to pay $15.0 million over ten years in equity contributions to these two new venture capital funds, of which $1.0 million was paid through June 30, 2003.

In April 2003, Chiron entered into a 15-year lease to rent an office building in Uxbridge, United Kingdom. The total minimum lease payments over the term of the lease are approximately 9.8 million British Pounds ($16.4 million at June 30, 2003). After 10 years, Chiron has the option to terminate or continue the lease, with one-year prior notice. This lease is accounted for as an operating lease.

There were no amounts drawn against any outstanding letters of credit at June 30, 2003. Effective April 1, 2003, the amount of insurance-related letters of credit was increased by $4.8 million.

Effective February 2003, Chiron and Baxter Pharmaceutical Solutions LLC executed an eight-year manufacturing and supply agreement. Under this agreement, Baxter agreed to perform certain manufacturing procedures and supply Chiron with