CHIRON CORP
Form 10-Q/A
April 06, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q/A

(Mark one)

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

For the quarterly period ended September 30, 2004

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 (State or other jurisdiction of incorporation or organization)	**94-2754624** (I.R.S. Employer Identification No.)
4560 Horton Street, Emeryville, California (Address of principal executive offices)	**94608** (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 October 29, 2004
Common Stock, $0.01 par value	186,839,927

EXPLANATORY NOTE

This Form 10Q/A (the Report) is being filed to amend Chiron Corporation s (the Company) Quarterly Report on Form 10-Q filed on November 2, 2004 (the Original Report), as previously amended on December 16, 2004, for the quarterly period ended September 30, 2004 to reflect the restatement of the Company s previously issued financial statements as of and for the three and nine month periods ended September 30, 2004, and the notes related thereto, as described below, and to make related changes. The information in this Report as of the date of the Original Report does not reflect subsequent results, events or developments. Such subsequent results, events or developments include, among others, the information and events subsequently described in our Quarterly Reports on Form 10-Q, our Annual Reports on Form 10-K and our Current Reports on Form 8-K. For a description of such subsequent results, events or developments, please read our Exchange Act Reports filed with the Securities and Exchange Commission since the date of the Original Report, which update and supersede information contained in the Original Report and this Report.

Chiron has determined that certain sales of a travel vaccine recorded as revenues in the second quarter of 2004 should not have been recorded as revenue at that time, and that portions of those sales should have been recorded as revenues in the third and fourth quarters of 2004 and possibly in later quarters. See Note 1 to Chiron s Condensed Consolidated Financial Statements, included herein, for additional discussion.

Chiron has reflected the results of the restatement for the fiscal year ended December 31, 2004 in its Annual Report on Form 10-K for such year, filed with the SEC on March 16, 2005 and has restated its interim financial statements in this Report and in an additional Quarterly Report on Form 10-Q/A for the quarterly period ended June 30, 2004.

In 2004, the Emerging Issues Task Force (EITF) reached a consensus on EITF Issue No. 04-8 The Effect of Contingently Convertible Instruments on Diluted Earnings per Share, that the dilutive effect of contingently convertible debt instruments (CoCo s) must be included in diluted earnings per share regardless of whether the triggering contingency has been satisfied, if dilutive. Adoption of Issue No. 04-8 would be on a retroactive basis and would require restatement of prior period diluted earnings per share. Chiron adopted EITF Issue No. 04-08 in the fourth quarter of 2004. The adoption of EITF Issue No. 04-08 did not result in additional dilution to our diluted earnings per share from our $500.0 million convertible debentures due 2033 nor from our $385.0 million convertible debentures due 2034 for the three and nine months ended September 30, 2004, as discussed in Note 2 to Chiron s Condensed Consolidated Financial Statements.

CHIRON CORPORATION

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Item 1. Financial Statements

CHIRON CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands, except share data)

	September 30, 2004 Restated	December 31, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 200,983	$ 364,270
Short-term investments in marketable debt securities	343,507	174,212
Total cash and short-term investments	544,490	538,482
Accounts receivable, net of allowances	397,802	382,933
Current portion of notes receivable		1,479
Inventories, net of reserves	218,589	199,625
Assets held for sale	2,754	2,992
Current net deferred income tax assets	60,232	50,204
Derivative financial instruments	7,599	9,463
Other current assets	65,229	72,471
Total current assets	1,296,695	1,257,649
Noncurrent investments in marketable debt securities	467,813	560,292
Property, plant, equipment and leasehold improvements, at cost:		
Land and buildings	371,382	366,275
Laboratory, production and office equipment	644,087	615,814
Leasehold improvements	116,602	112,200
Construction-in-progress	186,310	144,162
	1,318,381	1,238,451
Less accumulated depreciation and amortization	(566,988)	(548,701)
Property, plant, equipment and leasehold improvements, net	751,393	689,750
Purchased technologies, net	221,122	236,707
Goodwill	820,086	787,587
Other intangible assets, net	447,608	486,889
Investments in equity securities and affiliated companies	113,325	121,576
Equity method investments	709	953
Noncurrent notes receivable	7,500	7,500
Noncurrent derivative financial instruments		7,391
Other noncurrent assets	57,080	38,875
	$ 4,183,331	$ 4,195,169

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)

	September 30, 2004 Restated	December 31, 2003
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 113,045	$ 102,201
Accrued compensation and related expenses	78,470	83,311
Current portion of capital lease	944	570
Current portion of unearned revenue	37,802	47,873
Income taxes payable	4,746	15,270
Other current liabilities	159,886	187,688
Total current liabilities	394,893	436,913
Long-term debt	940,295	926,709
Capital lease	157,014	157,677
Noncurrent derivative financial instruments	4,928	
Noncurrent net deferred income tax liabilities	101,288	107,496
Noncurrent unearned revenue	30,525	45,564
Other noncurrent liabilities	86,462	69,448
Minority interest	8,498	7,002
Total liabilities	1,723,903	1,750,809
Commitments and contingencies		
Stockholders equity:		
Common stock	1,917	1,917
Additional paid-in capital	2,527,877	2,503,195
Deferred stock compensation	(15,572)	(12,871)
Retained earnings (Accumulated deficit)	16,269	(46,634)
Accumulated other comprehensive income	171,460	216,302
Treasury stock, at cost (4,999,000 shares at September 30, 2004 and 4,567,000 shares at December 31, 2003)	(242,523)	(217,549)
Total stockholders equity	2,459,428	2,444,360
	$ 4,183,331	$ 4,195,169

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 September 30, 2004 Restated	Three Months Ended September 30, 2003	Nine Months Ended September 30, 2004 Restated	Nine Months Ended September 30, 2003
Revenues:				
Product sales, net	$ 375,549	$ 432,674	$ 937,836	$ 897,222
Revenues from joint business arrangement	34,017	26,058	92,910	79,985
Collaborative agreement revenues	4,124	7,816	14,467	15,554
Royalty and license fee revenues	111,396	66,237	221,384	186,537
Other revenues	4,450	7,688	22,363	32,482
Total revenues	529,536	540,473	1,288,960	1,211,780
Operating expenses:				
Cost of sales (excludes amortization expense related to acquired developed products)	238,526	174,380	494,455	357,389
Research and development	103,000	97,519	301,736	269,564
Selling, general and administrative	114,531	105,818	326,128	259,086
Amortization expense	20,566	19,821	63,077	35,135
Purchased in-process research and development	9,629	122,700	9,629	122,700
Other operating expenses	1,280	4,779	8,040	7,729
Total operating expenses	487,532	525,017	1,203,065	1,051,603
Income from operations	42,004	15,456	85,895	160,177
Interest expense	(7,063)	(6,222)	(19,440)	(12,523)
Interest and other income, net	5,369	5,239	41,252	31,170
Minority interest	(504)	(443)	(1,583)	(1,424)
Income from continuing operations before income taxes	39,806	14,030	106,124	177,400
Provision for income taxes	12,359	34,183	28,938	75,025
Income (loss) from continuing operations	27,447	(20,153)	77,186	102,375
Gain (loss) from discontinued operations	(450)	1,174	24,854	3,138
Net income (loss)	$ 26,997	$ (18,979)	$ 102,040	$ 105,513
Basic earnings (loss) per share:				
Income (loss) from continuing operations	$ 0.15	$ (0.11)	$ 0.41	$ 0.55
Net income (loss)	$ 0.14	$ (0.10)	$ 0.54	$ 0.57
Diluted earnings (loss) per share:				
Income (loss) from continuing operations	$ 0.14	$ (0.11)	$ 0.40	$ 0.54
Net income (loss)	$ 0.14	$ (0.10)	$ 0.53	$ 0.55

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

CHIRON CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004 Restated	2003	2004 Restated	2003
Net income (loss)	$ 26,997	$ (18,979)	$ 102,040	$ 105,513
Other comprehensive income (loss):				
Change in foreign currency translation adjustment during the period	2,960	21,182	(34,452)	66,300
Unrealized gains (losses) from investments:				
Net unrealized holding gains (losses) arising during the period, net of tax (provision) benefit of ($5,977) and ($1,984) for the three months ended September 30, 2004 and 2003, respectively, and ($3,865) and ($3,268) for the nine months ended September 30, 2004 and 2003, respectively	(2,680)	4,200	4,864	6,840
Reclassification adjustment for net gains included in net income, net of tax (provision) of ($400) for the three months ended September 30, 2004, and ($9,753) and ($3,626) for the nine months ended September 30, 2004 and 2003, respectively	(625)		(15,254)	(5,744)
Net unrealized gains (losses) from investments	(3,305)	4,200	(10,390)	1,096
Other comprehensive income (loss)	(345)	25,382	(44,842)	67,396
Comprehensive income	$ 26,652	$ 6,403	$ 57,198	$ 172,909

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

CHIRON CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

	Nine Months Ended September 30, 2004 Restated	Nine Months Ended September 30, 2003
Net cash provided by operating activities	$ 132,633	$ 253,933
Cash flows from investing activities:		
Purchases of investments in marketable debt securities	(724,616)	(622,650)
Proceeds from sales of investments in marketable debt securities	415,100	748,041
Proceeds from maturities of investments in marketable debt securities	225,959	364,737
Capital expenditures	(134,079)	(81,372)
Purchases of equity securities and interests in affiliated companies	(6,216)	(4,270)
Proceeds from sale of equity securities and interests in affiliated companies	31,421	12,545
Cash paid for acquisitions, net of cash acquired	(32,289)	(804,728)
Other, net	(3,688)	(12,249)
Net cash used in investing activities	(228,408)	(399,946)
Cash flows from financing activities:		
Net repayment of short-term borrowings		(2,344)
Repayment of debt and capital leases	(380,159)	(62,341)
Payments to acquire treasury stock	(129,665)	(132,675)
Proceeds from re-issuance of treasury stock	64,178	85,995
Proceeds from issuance of debt	4,996	536
Payment of bond issuance costs	(8,285)	
Proceeds from issuance of convertible debentures	385,000	500,000
Proceeds from put options		2,144
Net cash (used in) provided by financing activities	(63,935)	391,315
Effect of exchange rate changes on cash and cash equivalents	(3,577)	6,655
Net (decrease) increase in cash and cash equivalents	(163,287)	251,957
Cash and cash equivalents at beginning of the period	364,270	247,950
Cash and cash equivalents at end of the period	$ 200,983	$ 499,907

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

CHIRON CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2004

(Unaudited)

Note 1 Basis of Presentation and Summary of Significant Accounting Policies

Basis of Presentation

The information presented in the Condensed Consolidated Financial Statements at September 30, 2004, and for the three and nine months ended September 30, 2004 and 2003, is unaudited but includes adjustments, consisting only of 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, 2003, 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 as of and for the year ended December 31, 2003, which are included in the Annual Report on Form 10-K filed by Chiron with the Securities and Exchange Commission.

Restatement of Financial Statements

Chiron determined that certain sales of a travel vaccine recorded as revenues in the second quarter of 2004 should not have been recorded as revenue at that time, and that portions of those sales should have been recorded as revenues in the third and fourth quarters of 2004 and possibly in later quarters.

As a result of the restatement, in the third quarter of 2004, product sales were increased by $5.6 million, cost of sales were increased by $0.9 million and income taxes were increased by $1.2 million. This resulted in a $3.5 million increase in income from continuing operations and net income and a $0.01 increase of diluted income from continuing operations per share ($0.14 per share instead of the $0.13 per share as previously reported). On the September 30, 2004 consolidated balance sheet, the current portion of unearned revenue increased by $7.6 million and income taxes payable decreased by $1.9 million.

As a result of the restatement, in the second quarter of 2004, product sales were reduced by $13.9 million, cost of sales were reduced by $1.5 million and income taxes were reduced by $3.1 million. This resulted in a $9.3 million reduction in income from continuing operations and net income and a $0.05 reduction of diluted income from continuing operations per share ($0.12 per share instead of the $0.17 per share as previously reported).

As a result of the restatement, for the nine months ended September 30, 2004, product sales were reduced by $8.3 million, cost of sales were reduced by $0.6 million and income taxes were reduced by $1.9 million. This resulted in a $5.8 million reduction in income from continuing operations and net income and a $0.03 reduction of diluted income from continuing operations per share ($0.40 per share instead of the $0.43 per share as previously reported).

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 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. All significant intercompany accounts and transactions have been eliminated in consolidation.

On July 8, 2003, Chiron acquired PowderJect Pharmaceuticals plc, a company based in Oxford, England that develops and commercializes vaccines. Chiron included PowderJect Pharmaceuticals operating results in its consolidated operating results beginning July 8, 2003. PowderJect Pharmaceuticals is part of Chiron s vaccines segment.

Chiron is a limited partner in several venture capital funds. Chiron is obligated to pay up to $60.0 million over ten years in equity contributions to these venture capital funds, of which approximately $38.4 million was paid through September 30, 2004. Chiron accounts for these investments under the equity method of accounting.

New Accounting Pronouncements

In October 2004, the Emerging Issues Task Force (EITF) reached a consensus on EITF Issue No. 04-8 The Effect of Contingently Convertible Instruments on Diluted Earnings per Share, that the dilutive effect of contingent convertible debt instruments (CoCo s) must be included in diluted earnings per share regardless of whether the triggering contingency has been satisfied, if dilutive. Adoption of Issue No. 04-8 would be on a retroactive basis and would require restatement of prior period diluted earnings per share, subject to certain transition provisions. It is effective for all periods ending after December 15, 2004. Accounting pursuant to this Issue would not result in additional dilution to Chiron s diluted earnings per share for the three and nine months ended September 30, 2004 from Chiron s $500.0 million convertible debentures due 2033 (2033 Debentures) nor from Chiron s $385.0 million convertible debentures due 2034 (2034 Debentures).

Financial Accounting Standards Board (or FASB) Interpretation No. 46 (or FIN 46), Consolidation of Variable Interest Entities, an interpretation of Accounting Research Bulletin No. 51 as revised, requires a variable interest entity (or VIE) to be consolidated by a company if that company absorbs a majority of the VIE s expected losses, receives a majority of the entity s expected residual returns, or both, as a result of ownership, contractual or other financial interest in the VIE. Prior to the adoption of FIN 46, VIEs were generally consolidated by companies owning a majority voting interest in the VIE. The consolidation requirements of FIN 46 applied immediately to VIEs created after January 31, 2003; however, the FASB deferred the effective date for VIEs created before February 1, 2003 to the quarter ended March 31, 2004 for calendar year companies. Adoption of the provisions of FIN 46 prior to the deferred effective date was permitted.

Chiron adopted the remaining provisions of FIN 46 in the first quarter of 2004. The adoption of these provisions did not have a material effect on Chiron s condensed consolidated financial statements.

On March 31, 2004, the FASB issued an Exposure Draft (ED), Share-Based Payment An Amendment of FASB Statements No. 123 and 95. The proposed Statement addresses the accounting for transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise s equity instruments or that may be settled by the issuance of such equity instruments. The proposed Statement would eliminate the ability to account for share-based compensation transactions using Accounting Principles Board Opinion No. 25 (APB 25) Accounting for Stock Issued to Employees, and generally would require instead that such transactions be accounted for using a fair-value based method. As proposed, companies would be required to recognize an expense for compensation cost related to share-based payment arrangements including stock options and employee stock purchase plans. As proposed, the new rules would be applied on a modified prospective basis as defined in the ED, and would be effective for Chiron beginning July 1, 2005. Chiron is currently evaluating option valuation methodologies and assumptions in light of the evolving accounting standards related to employee stock options. Current estimates of option values using the Black-Scholes method may not be indicative of results from valuation methodologies ultimately adopted in the final rules.

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; capital leases; intangible assets; goodwill; 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 includes Chiron s one-half share in the pretax operating earnings generated by the joint business contractual arrangement with Ortho-Clinical Diagnostics, Inc., a Johnson & Johnson company. Chiron accounts separately for research and development and manufacturing cost reimbursements and certain product sale revenues received from Ortho-Clinical Diagnostics, but relating to the joint business contractual arrangement. Chiron s joint business arrangement with Ortho-Clinical Diagnostics is 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 accounted for revenues relating to 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 Chiron s joint business contractual arrangement became available in the first quarter 2003, and as a result, Chiron is able to recognize revenues relating to 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 revenue from the joint business contractual arrangement for the nine months ended September 30, 2003.

Chiron currently owns a facility in London, England for international operations. This facility became available for sale in the fourth quarter of 2003. Chiron has committed to a plan to sell this facility and is actively marketing this facility. This facility is classified as Assets held for sale in the Condensed Consolidated Balance Sheet at September 30, 2004.

Chiron, prior to filing its financial statements on Form 10-Q, publicly releases an unaudited condensed balance sheet and statement of operations. Between the date of Chiron s earnings release and the filing of Form 10-Q, reclassifications may be required. These reclassifications, when made, have no effect on income from continuing operations, net income or earnings per share. There has been no such reclassification in the third quarter of 2004.

Certain previously reported amounts have been reclassified to conform to the current year presentation.

Inventories

Inventories, net of reserves, are stated at the lower of cost or market using the moving weighted-average cost method. Chiron maintains inventory reserves primarily for product failures, expiration and obsolescence. 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, if lower than cost.

Subsequent to the third quarter of 2004, the UK regulatory body, the Medicines and Healthcare products Regulatory Agency (MHRA), sent Chiron a letter prohibiting Chiron from releasing any Fluvirin doses manufactured at Chiron s Liverpool facility since March 2, 2004. In that letter, the MHRA asserted that Chiron s manufacturing process did not comply with U.K. good manufacturing practices regulations. In addition to prohibiting release of existing Fluvirin doses, the MHRA letter also suspended Chiron s license to manufacture further influenza virus vaccine in its Liverpool facility for three months. Chiron has not released any Fluvirin into any territory. Chiron wrote-off the entire inventory of Fluvirin product in the third quarter 2004, resulting in a $91.3 million charge to cost of sales.

Inventories, net of reserves consisted of the following:

		September 30, 2004		December 31, 2003
Finished goods	$	55,153	$	38,640
Work-in-process		116,596		105,359
Raw materials		46,840		55,626
	$	218,589	$	199,625

Income Taxes

The effective tax rate for the three and nine months ended September 30, 2004 was 31.0% and 27.3% respectively, of pretax income from continuing operations, including the charge for purchased in-process research and development related to the Sagres acquisition. See discussion in Note 4 Acquisitions . The effective tax rate for the three and nine months ended September 30, 2003 was 243.6% and 42.3% respectively, of pretax income from continuing operations, including the charge for purchased in-process research and development related to the PowderJect acquisition. The charges for the purchased in-process research and development in 2003 and 2004 are not tax deductible. The effective tax rate for the three and nine months ended September 30, 2004 and 2003 was 25% of pretax income from continuing operations, after excluding the impact of the purchased in-process research and development charges. The effective tax rate may be affected in future periods by changes in management s estimates with respect to our deferred tax assets and other items affecting the overall tax rate.

Stock-Based Compensation

Chiron measures compensation expense for its stock-based employee compensation plans using the intrinsic value method. 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.

The following table illustrates the effect on net income (loss) and related net income (loss) per share, had compensation cost for stock-based compensation plans been determined based upon the fair value method:

		Three Months Ended September 30,		Nine Months Ended September 30,	
		2004	**2003**	**2004**	**2003**
		(in thousands, except per share data)			
Net income (loss):					
As reported		$ 26,997	$ (18,979)	$ 102,040	$ 105,513
Add:	Stock-based employee compensation expense included in reported net income (loss), net of related tax effects	1,118	1,091	3,807	3,743
Less:	Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	23,778	20,741	68,055	58,786
	Pro forma	$ 4,337	$ (38,629)	$ 37,792	$ 50,470
Basic net income (loss) per share:					
As reported		$ 0.14	$ (0.10)	$ 0.54	$ 0.57
Pro forma		$ 0.02	$ (0.21)	$ 0.20	$ 0.27
Diluted net income (loss) per share:					
As reported		$ 0.14	$ (0.10)	$ 0.53	$ 0.55
Pro forma		$ 0.02	$ (0.21)	$ 0.20	$ 0.27

Comprehensive Income

For the three and nine months ended September 30, 2004 and 2003, the foreign currency translation component of comprehensive income relates to permanent investments in non-U.S. subsidiaries, and accordingly, was not adjusted for income taxes.

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 "Retained earnings / Accumulated deficit." Chiron charged losses of $9.0 million and $39.1 million for the three and nine months ended September 30, 2004, respectively, and $8.9 million and $40.3 million for the three and nine months ended September 30, 2003, respectively, to "Retained earnings / Accumulated deficit" in the Condensed Consolidated Balance Sheets.

Note 2 Earnings (Loss) 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, if applicable. Due to rounding, quarterly amounts may not sum fully to yearly amounts.

Contingently convertible debt instruments (CoCos) are included in diluted earnings per share, if dilutive. For the three and nine months ended September 30, 2004, Chiron s $500.0 million contingently convertible debentures due 2033 (2033 Debentures) and Chiron s $385.0 million contingently convertible debentures due 2034 (2034 Debentures) were excluded from the computations of diluted earnings per share as each of these CoCos were not dilutive.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	**2003**	**2004**	**2003**
Income (loss) (Numerator):				
Income (loss) from continuing operations	$ 27,447	$ (20,153)	$ 77,186	$ 102,375
Shares (Denominator):				
Weighted-average common shares outstanding	187,368	186,685	187,751	186,658
Effect of dilutive securities:				
Stock options and equivalents	2,646		3,150	3,828
Put options				2
Weighted-average common shares outstanding, plus impact from assumed conversions	190,014	186,685	190,901	190,488
Basic earnings (loss) per share	$ 0.15	$ (0.11)	$ 0.41	$ 0.55
Diluted earnings (loss) per share	$ 0.14	$ (0.11)	$ 0.40	$ 0.54

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	**2003**	**2004**	**2003**
Income (loss) (Numerator):				
Net income (loss)	$ 26,997	$ (18,979)	$ 102,040	$ 105,513
Shares (Denominator):				

Weighted-average common shares outstanding	187,368	186,685	187,751	186,658
Effect of dilutive securities:				
Stock options and equivalents	2,646		3,150	3,828
Put options				2
Weighted-average common shares outstanding, plus impact from assumed conversions	190,014	186,685	190,901	190,488
Basic earnings (loss) per share	$ 0.14	$ (0.10)	$ 0.54	$ 0.57
Diluted earnings (loss) per share	$ 0.14	$ (0.10)	$ 0.53	$ 0.55

For the three and nine months ended September 30, 2004, stock options to purchase 11.7 million and 10.1 million shares 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. For the three and nine months ended September 30, 2003, stock options to purchase 4.2 million and 10.7 million shares with exercise prices greater than the average market prices of common stock were excluded from the respective computations of diluted earnings (loss) per share as their inclusion would be antidilutive.

The dilutive effect of CoCos must be included in diluted earnings per share regardless of whether the triggering contingency has been satisfied, if dilutive. For the three and nine months ended September 30, 2004, 7.3 million shares of common stock issuable upon conversion of the 2033 Debentures were excluded from the computations of diluted earnings per share as their inclusion would be antidilutive. If the 2034 Debentures are tendered for conversion, the value (Conversion Value) of cash and shares of Chiron s common stock, if any, to be received by a holder converting $1,000 principal amount of the debentures will be determined by multiplying the applicable conversion rate by a weighted average price. Chiron will deliver the Conversion Value to debenture holders as follows: (1) an amount in cash (Principal Return) equal to the lesser of (a) the aggregate Conversion Value of the debentures to be converted and (b) the aggregate principal amount of the debentures to be converted and (2) if the aggregate Conversion Value of the debentures to be converted is greater that the Principal Return, an amount in shares (Net Shares) equal to the aggregate Conversion Value less the Principal Return (Net Share Amount). The number of Net Shares to be paid will be determined by dividing the Net Share Amount by a weighted average price. If dilutive, common shares to be added to the diluted shares outstanding would be determined by the net share settlement of the 2034 Debentures. For the three and nine months ended September 30, 2004, the assumed conversion of the 2034 Debentures was not dilutive.

For the three and nine months ended September 30, 2004, 0.6 million and 4.3 million shares of common stock that would be issued upon conversion of the Liquid Yield Option Notes (LYONs) were excluded from the computations of diluted earnings per share, as their inclusion would be antidilutive. For each of the three and nine months ended September 30, 2003, 5.2 million shares of common stock that would be issued upon conversion of the LYONs were excluded from the computation of diluted earnings (loss) per share, as their inclusion would be antidilutive. During the second quarter of 2004, Chiron was required to purchase a significant portion of the LYONs as discussed in Note 8 Debt Obligations .

Note 3 Discontinued Operations

In a strategic effort to focus on its core businesses of blood-testing, vaccines and biopharmaceuticals, Chiron completed the sale of Chiron Diagnostics and Chiron Vision in 1998 and 1997, respectively.

Chiron and Bayer Corporation, or Bayer, were involved in a dispute with respect to their respective rights to certain royalty refunds receivable for which a settlement was reached in 2004. Under this settlement agreement, Chiron made a settlement payment to Bayer in 2004. This settlement includes an agreement that all outstanding items with Bayer related to the sale of Chiron Diagnostics are resolved and no future indemnity obligations are required. Chiron released previously established reserves deemed to be excess following this settlement. This settlement resulted in a net gain of $12.8 million, which was included in Gain (loss) from discontinued operations for the nine months ended September 30, 2004. This net gain primarily relates to a tax benefit as a result of the settlement payment to Bayer.

In the second quarter 2004, Chiron and the IRS entered into a settlement agreement closing the open tax years 1996 to 1998. Pursuant to this settlement agreement Chiron recognized a tax benefit of approximately $12.5 million, which was included in Gain (loss) from discontinued operations for the nine months ended September 30, 2004.

In the third quarter 2003, Chiron reversed approximately $1.2 million, net of tax, related to unutilized reserves for Chiron Diagnostics, which was included in Gain (loss) from discontinued operations for the three and nine months ended September 30, 2003.

In the first quarter 2003, Chiron and Bayer 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. Pursuant to this settlement, Chiron recorded a charge, net of adjustment to its previously provided reserve for indemnity obligations, 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 included in Gain (loss) from discontinued operations for the nine months ended September 30, 2003.

Note 4 Acquisitions

Sagres Discovery On July 2, 2004, Chiron acquired Sagres Discovery (Sagres), a privately held company headquartered in Davis, California, which focuses on the discovery and validation of targets with potential application to the development of cancer therapeutics. Chiron acquired Sagres for a preliminary purchase price of $12.0 million.

Sagres is part of Chiron s biopharmaceuticals segment. Chiron accounted for the acquisition as an asset purchase and included Sagres s operating results in its consolidated operating results beginning on July 2, 2004. The components of the preliminary purchase price and allocation thereof based on estimated fair values are summarized in the following table (in thousands). The preliminary purchase price reflects acquisition costs, which include contractual severance, direct acquisition costs and facility exit costs. Chiron is in the process of finalizing certain estimates including those for severance and facility exit costs for certain research facilities; thus both the preliminary purchase price and the allocation of the preliminary purchase price are subject to change.

Consideration and acquisition costs:		
Cash paid for asset purchase	$	10,057
Cash payable for asset purchase		837
Acquisition costs paid as of September 30, 2004		1,082
Acquisition costs not yet paid as of September 30, 2004		47
Total preliminary purchase price	$	12,023

Allocation of preliminary purchase price:		
Assets acquired	$	1,698
Liabilities assumed		(724)
Deferred tax assets		1,420
Purchased in-process research and development		9,629
Total preliminary purchase price	$	12,023

Chiron allocated the preliminary purchase price based on the fair value of the assets acquired and liabilities assumed. Chiron allocated a portion of the preliminary purchase price to purchased in-process research and development, which it charged to earnings in the third quarter 2004.

For acquisition costs related to Sagres, Chiron paid $1.1 million for the nine months ended September 30, 2004. 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 nine months ended September 30, 2004.

The deferred tax assets primarily related to future utilization of net operating loss carryforwards. Chiron acquired federal and state net operating loss carryforwards of approximately $25.0 million and $20.6 million, respectively and federal and state business credits attributed to Sagres of approximately $1.7 million and $1.3 million, respectively. The available utilization of such net operating loss and business tax credit carryforwards is limited in any one year to approximately $0.2 million per annum over the next twenty years under provisions of the Internal Revenue Code. As such, a significant portion of Sagres s net operating loss carryforwards is expected to expire unutilized.

PowderJect Pharmaceuticals plc On July 8, 2003, Chiron acquired PowderJect Pharmaceuticals, a company based in Oxford, England that develops and commercializes vaccines. Chiron acquired all of the outstanding shares of common stock of PowderJect Pharmaceuticals for 550 pence per ordinary share, which, including estimated acquisition costs, resulted in a total purchase price of approximately $940.3 million.

During the second quarter 2004, Chiron completed the planned divestiture of certain research operations in Madison, Wisconsin and Oxford, England and certain vaccines operations in Sweden. The divestiture of these operations included the disposition of net assets of $14.7 million (which included $15.5 million of cash), deferred taxes of $9.4 million, and exit liabilities of $21.6 million. The net impact of the divestiture resulted in an increase to goodwill of $2.5 million in the second quarter 2004. Also, during the second quarter of 2004, Chiron adjusted the previously recorded obligation related to an assumed defined benefit plan, which resulted in an increase to goodwill of $8.1 million.

During the third quarter 2004, Chiron revised estimates of exit costs associated with certain contractual obligations under supply and research agreements related to the divested research operations and other direct acquisition costs. Also, during the third quarter 2004, Chiron revised estimates of exit costs associated with the divestiture of certain research operations in Madison, Wisconsin. The net impact of the revision of these estimates resulted in an increase to goodwill of $14.0 million, an increase to acquisition costs of $14.5 million and a decrease to current liabilities assumed of $0.5 million. As a result of these adjustments to exit costs, the purchase price was revised to $940.3 million.

PowderJect Pharmaceuticals is part of Chiron s vaccines segment. Chiron accounted for the acquisition as a business combination and included PowderJect Pharmaceuticals operating results in its consolidated operating results beginning July 8, 2003.

The components of the purchase price, and the allocation thereof based on estimated fair values are summarized in the following table (in thousands).

Consideration and acquisition costs:		
Cash paid for common stock	$	831,026
Cash paid for options on common stock		59,153
Acquisition costs paid as of September 30, 2004		22,340
Acquisition costs not yet paid as of September 30, 2004		27,827
Total purchase price		