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

**Form 10-Q**

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

**FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2011**

Commission File Number 001-16407



**ZIMMER HOLDINGS, INC.**

*(Exact name of registrant as specified in its charter)*

**Delaware**  
*(State or other jurisdiction of  
incorporation or organization)*

13-4151777  
*(IRS Employer  
Identification No.)*

**345 East Main Street, Warsaw, IN 46580**  
*(Address of principal executive offices)*  
**Telephone: (574) 267-6131**

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 ☒ No ☐

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

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

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

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

As of July 25, 2011, 190,474,286 shares of the registrant's \$.01 par value common stock were outstanding.

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**ZIMMER HOLDINGS, INC.**

**INDEX TO FORM 10-Q**

**June 30, 2011**

	<u>Page</u>
<b>Part I — Financial Information</b>	
<b>Item 1.</b> Condensed Financial Statements	
Condensed Consolidated Statements of Earnings for the Three and Six Months Ended June 30, 2011 and 2010 . . . . .	3
Condensed Consolidated Balance Sheets as of June 30, 2011 and December 31, 2010 . . . . .	4
Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2011 and 2010 . . . . .	5
Notes to Interim Condensed Consolidated Financial Statements . . . . .	6
<b>Item 2.</b> Management’s Discussion and Analysis of Financial Condition and Results of Operations . .	22
<b>Item 3.</b> Quantitative and Qualitative Disclosures About Market Risk. . . . .	32
<b>Item 4.</b> Controls and Procedures . . . . .	33
<b>Part II — Other Information</b>	
There is no information required to be reported under any items except those indicated below	
<b>Item 1.</b> Legal Proceedings . . . . .	33
<b>Item 1A.</b> Risk Factors . . . . .	33
<b>Item 2.</b> Unregistered Sales of Equity Securities and Use of Proceeds . . . . .	33
<b>Item 5.</b> Other Information . . . . .	34
<b>Item 6.</b> Exhibits . . . . .	34
<b>Signatures</b> . . . . .	35

## Part I — Financial Information

### Item 1. *Financial Statements*

#### ZIMMER HOLDINGS, INC. AND SUBSIDIARIES

#### CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

(In millions, except per share amounts, unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
<b>Net Sales</b> . . . . .	\$1,137.4	\$1,057.7	\$2,253.0	\$2,120.5
Cost of products sold. . . . .	287.9	250.6	566.9	519.0
<b>Gross Profit</b> . . . . .	849.5	807.1	1,686.1	1,601.5
Research and development. . . . .	57.0	54.2	112.6	104.7
Selling, general and administrative. . . . .	469.9	438.3	928.2	885.5
Certain claims (Note 15) . . . . .	50.0	75.0	50.0	75.0
Special items (Note 2) . . . . .	13.5	11.5	39.0	14.1
Operating expenses . . . . .	590.4	579.0	1,129.8	1,079.3
<b>Operating Profit</b> . . . . .	259.1	228.1	556.3	522.2
Interest expense, net . . . . .	9.8	14.3	20.8	28.9
Earnings before income taxes . . . . .	249.3	213.8	535.5	493.3
Provision for income taxes . . . . .	45.5	48.3	122.8	122.4
<b>Net Earnings of Zimmer Holdings, Inc.</b> . . . . .	<u>\$ 203.8</u>	<u>\$ 165.5</u>	<u>\$ 412.7</u>	<u>\$ 370.9</u>
<b>Earnings Per Common Share</b>				
Basic. . . . .	\$ 1.06	\$ 0.82	\$ 2.15	\$ 1.83
Diluted . . . . .	\$ 1.06	\$ 0.82	\$ 2.14	\$ 1.82
<b>Weighted Average Common Shares Outstanding</b>				
Basic. . . . .	191.5	201.9	192.1	202.4
Diluted . . . . .	192.7	203.0	193.3	203.6

The accompanying notes are an integral part of these consolidated financial statements.

**ZIMMER HOLDINGS, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(In millions, unaudited)

	<u>June 30, 2011</u>	<u>December 31, 2010</u>
<b>ASSETS</b>		
<b>Current Assets:</b>		
Cash and cash equivalents . . . . .	\$ 624.1	\$ 668.9
Short-term investments . . . . .	321.4	265.1
Accounts receivable, less allowance for doubtful accounts . . . . .	888.4	775.9
Inventories, net. . . . .	975.1	936.4
Prepaid expenses and other current assets . . . . .	66.7	127.7
Deferred income taxes . . . . .	<u>232.6</u>	<u>235.7</u>
Total Current Assets . . . . .	3,108.3	3,009.7
Property, plant and equipment, net . . . . .	1,213.0	1,213.8
Goodwill . . . . .	2,694.0	2,580.8
Intangible assets, net . . . . .	811.5	827.1
Other assets . . . . .	<u>422.4</u>	<u>368.5</u>
<b>Total Assets . . . . .</b>	<b><u>\$ 8,249.2</u></b>	<b><u>\$ 7,999.9</u></b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current Liabilities:</b>		
Accounts payable . . . . .	\$ 124.0	\$ 129.6
Income taxes . . . . .	31.1	48.9
Other current liabilities . . . . .	<u>523.9</u>	<u>524.0</u>
Total Current Liabilities . . . . .	679.0	702.5
Other long-term liabilities . . . . .	407.1	384.0
Long-term debt . . . . .	<u>1,147.3</u>	<u>1,142.1</u>
<b>Total Liabilities . . . . .</b>	<b><u>2,233.4</u></b>	<b><u>2,228.6</u></b>
<b>Commitments and Contingencies (Note 15)</b>		
<b>Stockholders' Equity:</b>		
Common stock, \$0.01 par value, one billion shares authorized, 255.5 million (254.6 million in 2010) issued . . . . .	2.5	2.5
Paid-in capital . . . . .	3,355.4	3,293.5
Retained earnings . . . . .	6,111.3	5,699.4
Accumulated other comprehensive income. . . . .	447.5	321.0
Treasury stock, 65.1 million shares (59.0 million shares in 2010) . . . . .	<u>(3,900.9)</u>	<u>(3,545.1)</u>
<b>Total Stockholders' Equity . . . . .</b>	<b><u>6,015.8</u></b>	<b><u>5,771.3</u></b>
<b>Total Liabilities and Stockholders' Equity . . . . .</b>	<b><u>\$ 8,249.2</u></b>	<b><u>\$ 7,999.9</u></b>

The accompanying notes are an integral part of these consolidated financial statements.

**ZIMMER HOLDINGS, INC. AND SUBSIDIARIES**  
**CONSENSUED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In millions, unaudited)

	<u>For the Six Months Ended June 30,</u>	
	<u>2011</u>	<u>2010</u>
<b>Cash flows provided by (used in) operating activities:</b>		
Net earnings of Zimmer Holdings, Inc. . . . .	\$ 412.7	\$ 370.9
Adjustments to reconcile net earnings to cash provided by operating activities:		
Depreciation and amortization . . . . .	174.7	165.8
Share-based compensation . . . . .	31.7	30.6
Income tax benefit from stock option exercises . . . . .	9.5	2.9
Excess income tax benefit from stock option exercises . . . . .	(3.6)	(1.0)
Inventory step-up . . . . .	7.8	1.3
Changes in operating assets and liabilities, net of effect of acquisitions:		
Income taxes . . . . .	(11.5)	(70.5)
Receivables . . . . .	(76.0)	(51.3)
Inventories . . . . .	(21.8)	27.5
Accounts payable and accrued expenses . . . . .	(42.2)	(37.4)
Other assets and liabilities . . . . .	<u>(48.1)</u>	<u>93.4</u>
Net cash provided by operating activities . . . . .	<u>433.2</u>	<u>532.2</u>
<b>Cash flows provided by (used in) investing activities:</b>		
Additions to instruments . . . . .	(85.2)	(83.1)
Additions to other property, plant and equipment . . . . .	(34.0)	(26.7)
Purchases of investments . . . . .	(186.7)	(4.0)
Sales of investments . . . . .	169.8	37.0
Investments in other assets . . . . .	<u>(26.4)</u>	<u>(15.1)</u>
Net cash used in investing activities . . . . .	<u>(162.5)</u>	<u>(91.9)</u>
<b>Cash flows provided by (used in) financing activities:</b>		
Net proceeds under revolving credit facilities . . . . .	0.2	—
Proceeds from employee stock compensation plans . . . . .	29.1	8.1
Excess income tax benefit from stock option exercises . . . . .	3.6	1.0
Repurchase of common stock . . . . .	<u>(357.2)</u>	<u>(178.9)</u>
Net cash used in financing activities . . . . .	<u>(324.3)</u>	<u>(169.8)</u>
Effect of exchange rates on cash and cash equivalents . . . . .	<u>8.8</u>	<u>(8.5)</u>
Increase (decrease) in cash and cash equivalents . . . . .	(44.8)	262.0
Cash and cash equivalents, beginning of year . . . . .	<u>668.9</u>	<u>691.7</u>
Cash and cash equivalents, end of period . . . . .	<u>\$ 624.1</u>	<u>\$ 953.7</u>

The accompanying notes are an integral part of these consolidated financial statements.

**ZIMMER HOLDINGS, INC. AND SUBSIDIARIES**  
**NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. Basis of Presentation**

The financial data presented herein is unaudited and should be read in conjunction with the consolidated financial statements and accompanying notes included in the 2010 Annual Report on Form 10-K filed by Zimmer Holdings, Inc. In our opinion, the accompanying unaudited condensed consolidated financial statements include all adjustments necessary for a fair statement of the financial position, results of operations and cash flows for the interim periods presented. The December 31, 2010 condensed balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. Results for interim periods should not be considered indicative of results for the full year. Certain amounts in the 2010 condensed consolidated financial statements have been reclassified to conform to the 2011 presentation.

The words “we,” “us,” “our” and similar words refer to Zimmer Holdings, Inc. and its subsidiaries. Zimmer Holdings refers to the parent company only.

**2. Significant Accounting Policies**

*Special Items* — We recognize expenses resulting directly from our business combinations, employee termination benefits, certain contract terminations and asset impairment charges connected with global restructuring and transformation initiatives, and other items as “Special items” in our condensed consolidated statement of earnings. “Special items” included (in millions):

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Impairment/loss on disposal of assets . . . . .	\$ 0.4	\$ 7.7	\$ 2.9	\$ 8.1
Consulting and professional fees . . . . .	4.9	0.9	8.4	1.9
Employee severance and retention . . . . .	3.6	2.3	19.8	2.2
Information technology integration . . . . .	—	—	—	0.1
Facility and employee relocation . . . . .	0.6	0.5	0.9	0.5
Distributor acquisitions . . . . .	0.5	—	1.1	—
Certain litigation matters . . . . .	—	(0.5)	0.1	(1.3)
Contract terminations . . . . .	1.7	0.6	2.7	2.6
Other . . . . .	1.8	—	3.1	—
Special items . . . . .	<u>\$13.5</u>	<u>\$11.5</u>	<u>\$39.0</u>	<u>\$14.1</u>

In the first six months of 2011 we terminated employees as part of a reduction of management layers, expansion of management spans of control, and changes in our organizational structure. Approximately 500 employees from across the globe were affected by these actions. As a result, we incurred expenses related to severance benefits, share-based compensation acceleration and other employee termination-related costs. The vast majority of these termination benefits were provided in accordance with our existing or local government policies and are considered ongoing benefits. These costs were accrued when they became probable and estimable and were recorded as part of other current liabilities. The majority of these costs have been paid or will be paid by the end of 2011.

*Recent Accounting Pronouncements* — There are no recently issued accounting pronouncements that we have not yet adopted that are expected to have a material effect on our financial position, results of operations or cash flows.

# ZIMMER HOLDINGS, INC. AND SUBSIDIARIES

## NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### 3. Comprehensive Income

The reconciliation of net earnings to comprehensive income is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
	(In millions)		(In millions)	
Net earnings of Zimmer Holdings, Inc. . . . .	\$203.8	\$165.5	\$412.7	\$ 370.9
Other Comprehensive Income:				
Foreign currency cumulative translation adjustments . . . .	38.9	(97.0)	169.6	(179.4)
Unrealized cash flow hedge gains/(losses), net of tax . . . .	(10.9)	24.3	(58.2)	53.0
Reclassification adjustments on foreign currency hedges, net of tax . . . . .	8.8	(8.3)	13.2	(9.2)
Unrealized gains on securities, net of tax . . . . .	0.3	—	0.5	—
Adjustments to prior service cost and unrecognized actuarial assumptions, net of tax . . . . .	0.7	0.2	1.4	1.1
Total Other Comprehensive Gain/(Loss) . . . . .	37.8	(80.8)	126.5	(134.5)
Comprehensive Income Attributable to Zimmer Holdings, Inc. . . . .	<u>\$241.6</u>	<u>\$ 84.7</u>	<u>\$539.2</u>	<u>\$ 236.4</u>

### 4. Inventories

	June 30, 2011	December 31, 2010
	(In millions)	
Finished goods . . . . .	\$792.4	\$757.3
Work in progress . . . . .	53.5	47.0
Raw materials . . . . .	129.2	132.1
Inventories, net . . . . .	<u>\$975.1</u>	<u>\$936.4</u>

### 5. Property, Plant and Equipment

	June 30, 2011	December 31, 2010
	(In millions)	
Land . . . . .	\$ 22.3	\$ 22.0
Buildings and equipment . . . . .	1,199.0	1,162.0
Capitalized software costs . . . . .	179.9	172.0
Instruments . . . . .	1,448.6	1,365.6
Construction in progress . . . . .	65.9	66.5
	2,915.7	2,788.1
Accumulated depreciation . . . . .	<u>(1,702.7)</u>	<u>(1,574.3)</u>
Property, plant and equipment, net . . . . .	<u>\$ 1,213.0</u>	<u>\$ 1,213.8</u>

# ZIMMER HOLDINGS, INC. AND SUBSIDIARIES

## NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### 6. Investments

We invest in short and long-term investments classified as available-for-sale securities. Information regarding our investments is as follows (in millions):

	<u>Amortized Cost</u>	<u>Gross Unrealized</u>		<u>Fair value</u>
		<u>Gains</u>	<u>Losses</u>	
<b>As of June 30, 2011</b>				
Corporate debt securities . . . . .	\$240.4	\$0.3	\$(0.1)	\$240.6
U.S. government and agency debt securities . . . . .	37.9	—	—	37.9
Municipal bonds . . . . .	1.0	—	—	1.0
Foreign government debt securities . . . . .	7.5	—	—	7.5
Commercial paper . . . . .	9.5	—	—	9.5
Certificates of deposit . . . . .	129.1	0.1	—	129.2
Total short and long-term investments . . . . .	<u>\$425.4</u>	<u>\$0.4</u>	<u>\$(0.1)</u>	<u>\$425.7</u>
<b>As of December 31, 2010</b>				
Corporate debt securities . . . . .	\$203.9	\$0.1	\$(0.2)	\$203.8
U.S. government and agency debt securities . . . . .	47.9	—	—	47.9
Municipal bonds . . . . .	1.1	—	—	1.1
Foreign government debt securities . . . . .	10.3	—	—	10.3
Commercial paper . . . . .	16.1	—	—	16.1
Certificates of deposit . . . . .	131.5	—	(0.1)	131.4
Total short and long-term investments . . . . .	<u>\$410.8</u>	<u>\$0.1</u>	<u>\$(0.3)</u>	<u>\$410.6</u>

Unrealized gains and losses on these investments are recorded in accumulated other comprehensive income in our consolidated balance sheet.

The following table shows the fair value and gross unrealized losses for all available-for-sale securities in an unrealized loss position deemed to be temporary (in millions):

	<u>As of June 30, 2011</u>		<u>As of December 31, 2010</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair value</u>	<u>Unrealized Losses</u>
Corporate debt securities . . . . .	\$62.4	\$(0.1)	\$126.1	\$(0.2)
Certificates of deposit . . . . .	—	—	50.6	(0.1)
Total . . . . .	<u>\$62.4</u>	<u>\$(0.1)</u>	<u>\$176.7</u>	<u>\$(0.3)</u>

All securities in the table above have been in an unrealized loss position for less than twelve months. A total of 36 securities were in an unrealized loss position as of June 30, 2011.

The unrealized losses on our investments in corporate debt securities were caused by increases in interest yields resulting from adverse conditions in the global credit markets. We believe the unrealized losses associated with our available-for-sale securities as of June 30, 2011 are temporary because we do not intend to sell these investments before maturity, and we do not believe we will be required to sell them before recovery of their amortized cost basis.



# ZIMMER HOLDINGS, INC. AND SUBSIDIARIES

## NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The amortized cost and fair value of our available-for-sale fixed-maturity securities by contractual maturity are as follows (in millions):

	As of June 30, 2011	
	Amortized Cost	Fair Value
Due in one year or less . . . . .	\$321.2	\$321.4
Due after one year through two years . . . . .	104.2	104.3
Total . . . . .	<u>\$425.4</u>	<u>\$425.7</u>

### 7. Other Current Liabilities

	June 30, 2011	December 31, 2010
	(In millions)	
Other current liabilities:		
Salaries, wages and benefits . . . . .	\$ 88.9	\$118.1
Fair value of derivatives . . . . .	43.2	29.4
Accrued liabilities . . . . .	<u>391.8</u>	<u>376.5</u>
Total other current liabilities . . . . .	<u>\$523.9</u>	<u>\$524.0</u>

### 8. Debt

We had no short-term debt as of June 30, 2011 or December 31, 2010. Long-term debt as of June 30, 2011 and December 31, 2010 on our condensed consolidated balance sheet consisted of the following (in millions):

	June 30, 2011	December 31, 2010
Senior Notes due 2019 . . . . .	\$ 500.0	\$ 500.0
Senior Notes due 2039 . . . . .	500.0	500.0
Debt discount . . . . .	(1.2)	(1.2)
Interest rate swaps . . . . .	5.5	1.5
Senior Credit Facility . . . . .	<u>143.0</u>	<u>141.8</u>
Total long-term debt . . . . .	<u>\$1,147.3</u>	<u>\$1,142.1</u>

The estimated fair value of our Senior Notes as of June 30, 2011, based on quoted prices for the specific securities from transactions in over-the-counter markets, was \$1,039.4 million. The carrying value of the Senior Credit Facility approximates fair value, as the underlying instruments have variable interest rates at market value.

**ZIMMER HOLDINGS, INC. AND SUBSIDIARIES**  
**NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**9. Fair Value Measurement of Assets and Liabilities**

The following assets and liabilities are recorded at fair value on a recurring basis (in millions):

<u>Description</u>	<u>As of June 30, 2011</u>			
	<u>Fair Value Measurements at Reporting Date Using:</u>			
	<u>Recorded Balance</u>	<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
<b>Assets</b>				
Available-for-sale securities				
Corporate debt securities . . . . .	\$240.6	\$—	\$240.6	\$—
U.S. government and agency debt securities . .	37.9	—	37.9	—
Municipal bonds . . . . .	1.0	—	1.0	—
Foreign government debt securities . . . . .	7.5	—	7.5	—
Commercial paper . . . . .	9.5	—	9.5	—
Certificates of deposit . . . . .	<u>129.2</u>	<u>—</u>	<u>129.2</u>	<u>—</u>
Total available-for-sale securities . . . . .	425.7	—	425.7	—
Derivatives, current and long-term				
Foreign currency forward contracts and options . . . . .	6.8	—	6.8	—
Interest rate swaps . . . . .	<u>5.5</u>	<u>—</u>	<u>5.5</u>	<u>—</u>
	<u>\$438.0</u>	<u>\$—</u>	<u>\$438.0</u>	<u>\$—</u>
<b>Liabilities</b>				
Derivatives, current and long-term				
Foreign currency forward contracts and options . . . . .	\$ 61.9	\$—	\$ 61.9	\$—
Cross-currency interest rate swaps . . . . .	<u>3.3</u>	<u>—</u>	<u>3.3</u>	<u>—</u>
	<u>\$ 65.2</u>	<u>\$—</u>	<u>\$ 65.2</u>	<u>\$—</u>

# ZIMMER HOLDINGS, INC. AND SUBSIDIARIES

## NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Description	As of December 31, 2010			
	Fair Value Measurements at Reporting Date			
	Using:			
	Recorded Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Available-for-sale securities				
Corporate debt securities . . . . .	\$203.8	\$—	\$203.8	\$—
U.S. government and agency debt securities . .	47.9	—	47.9	—
Municipal bonds . . . . .	1.1	—	1.1	—
Foreign government debt securities . . . . .	10.3	—	10.3	—
Commercial paper . . . . .	16.1	—	16.1	—
Certificates of deposit . . . . .	<u>131.4</u>	<u>—</u>	<u>131.4</u>	<u>—</u>
Total available-for-sale securities . . . . .	410.6	—	410.6	—
Derivatives, current and long-term				
Foreign currency forward contracts and options . . . . .	34.5	—	34.5	—
Interest rate swaps . . . . .	<u>1.5</u>	<u>—</u>	<u>1.5</u>	<u>—</u>
	<u>\$446.6</u>	<u>\$—</u>	<u>\$446.6</u>	<u>\$—</u>
<b>Liabilities</b>				
Derivatives, current and long-term				
Foreign currency forward contracts and options . . . . .	<u>\$ 40.0</u>	<u>\$—</u>	<u>\$ 40.0</u>	<u>\$—</u>
	<u>\$ 40.0</u>	<u>\$—</u>	<u>\$ 40.0</u>	<u>\$—</u>

We value our available-for-sale securities using a market approach based on broker prices for identical assets in over-the-counter markets.

We value our foreign currency forward contracts and foreign currency options using a market approach based on foreign currency exchange rates obtained from active markets and perform ongoing assessments of counterparty credit risk.

We value our interest rate swaps using a market approach based on publicly available market yield curves and the terms of our swaps.

We value our cross-currency interest rate swaps using a market approach based upon publicly available market yield curves, foreign currency exchange rates obtained from active markets and the terms of our swaps. We also perform ongoing assessments of counterparty credit risk.

### 10. Derivative Instruments and Hedging Activities

We are exposed to certain market risks relating to our ongoing business operations, including foreign currency exchange rate risk, commodity price risk, interest rate risk and credit risk. We manage our exposure to these and other market risks through regular operating and financing activities. Currently, the only risks that we manage through the use of derivative instruments are interest rate risk and foreign currency exchange rate risk.

## ZIMMER HOLDINGS, INC. AND SUBSIDIARIES

### NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

#### **Interest Rate Risk**

##### *Derivatives Designated as Fair Value Hedges*

We use interest rate derivative instruments to manage our exposure to interest rate movements by converting fixed-rate debt into variable-rate debt. Under these agreements, we agree to exchange, at specified intervals, the difference between fixed and variable interest amounts calculated by reference to an agreed-upon notional principal amount. The objective of the instruments is to more closely align interest expense with interest income received on cash and cash equivalents. These derivative instruments are designated as fair value hedges under U.S. generally accepted accounting principles (GAAP). Changes in the fair value of the derivative instrument are recorded in current earnings and are offset by gains or losses on the underlying debt instrument.

In 2010, we entered into multiple nine-year fixed-to-variable interest rate swap agreements with a total notional amount of \$250 million. These interest rate swap agreements were designated as fair value hedges of the fixed interest rate obligation under our \$500 million 4.625 percent Senior Notes due November 30, 2019. We receive a fixed interest rate of 4.625 percent and pay variable interest equal to the three-month LIBOR plus an average of 133 basis points on these interest rate swap agreements.

#### **Foreign Currency Exchange Rate Risk**

We operate on a global basis and are exposed to the risk that our financial condition, results of operations and cash flows could be adversely affected by changes in foreign currency exchange rates. To reduce the potential effects of foreign currency exchange rate movements on net earnings, we enter into derivative financial instruments in the form of foreign currency exchange forward contracts and options with major financial institutions. We are primarily exposed to foreign currency exchange rate risk with respect to transactions and net assets denominated in Euros, Swiss Francs, Japanese Yen, British Pounds, Canadian Dollars, Australian Dollars, Korean Won, Swedish Krona, Czech Koruna, Thai Baht, Taiwan Dollars, South African Rand, Russian Rubles and Indian Rupees. We do not use derivative financial instruments for trading or speculative purposes.

##### *Derivatives Designated as Cash Flow Hedges*

Our revenues are generated in various currencies throughout the world. However, a significant amount of our inventory is produced in U.S. Dollars. Therefore, movements in foreign currency exchange rates may have different proportional effects on our revenues compared to our cost of products sold. To minimize the effects of foreign currency exchange rate movements on cash flows, we hedge intercompany sales of inventory expected to occur within the next 30 months with foreign currency exchange forward contracts and options. We designate these derivative instruments as cash flow hedges.

We perform quarterly assessments of hedge effectiveness by verifying and documenting the critical terms of the hedge instrument and that forecasted transactions have not changed significantly. We also assess on a quarterly basis whether there have been adverse developments regarding the risk of a counterparty default. For derivatives which qualify as hedges of future cash flows, the effective portion of changes in fair value is temporarily recorded in other comprehensive income and then recognized in cost of products sold when the hedged item affects net earnings. The ineffective portion of a derivative's change in fair value, if any, is immediately reported in cost of products sold.

For forward contracts and options outstanding at June 30, 2011, we have obligations to purchase U.S. Dollars and sell Euros, Japanese Yen, British Pounds, Canadian Dollars, Australian Dollars, Korean Won, Swedish Krona, Czech Koruna, Thai Baht, Taiwan Dollars, South African Rand, Russian Rubles and Indian Rupees and purchase Swiss Francs and sell U.S. Dollars at set maturity dates ranging from July 2011 through December 2013. As of June 30, 2011, the notional amounts of outstanding forward contracts and options entered into with third parties to purchase U.S. Dollars were \$1.4 billion. As of June 30, 2011, the notional amounts of outstanding forward contracts and options entered into with third parties to purchase Swiss Francs were \$183.8 million.

## ZIMMER HOLDINGS, INC. AND SUBSIDIARIES

### NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

#### *Derivatives Not Designated as Hedging Instruments*

We enter into foreign currency forward exchange contracts with terms of one month to manage currency exposures for monetary assets and liabilities denominated in a currency other than an entity's functional currency. As a result, any foreign currency remeasurement gains/losses recognized in earnings are generally offset with gains/losses on the foreign currency forward exchange contracts in the same reporting period. These offsetting gains/losses are recorded in cost of products sold as the underlying assets and liabilities exposed to remeasurement include inventory-related transactions. These contracts are settled on the last day of each reporting period. Therefore, there is no outstanding balance related to these contracts recorded on the balance sheet as of the end of the reporting period. The notional amounts of these contracts are typically in a range of \$1.2 billion to \$1.7 billion per quarter.

#### **Foreign Currency Exchange and Interest Rate Risk**

##### *Derivatives Designated as Cash Flow Hedges*

In 2011, our Japan subsidiary, with a functional currency of Japanese Yen, borrowed variable-rate debt of \$143.0 million denominated in U.S. Dollars under our Senior Credit Facility. To manage the foreign currency exchange risk associated with remeasuring the debt to Japanese Yen and the interest rate risk associated with the variable-rate debt, we have entered into multiple cross-currency interest rate swap agreements with a total notional amount of 11,798 million Japanese Yen. We designated these swaps as cash flow hedges of the foreign currency exchange and interest rate risks. The effective portion of changes in fair value of the cross-currency interest rate swaps is temporarily recorded in other comprehensive income and then recognized in interest expense, net when the hedged item affects net earnings. We pay a fixed interest rate of 0.1 percent and receive variable interest equal to the three-month LIBOR plus 18.5 basis points on these cross-currency interest rate swap agreements.

#### **Income Statement Presentation**

##### *Derivatives Designated as Fair Value Hedges*

Derivative instruments designated as fair value hedges had the following effects on our condensed consolidated statement of earnings (in millions):

<u>Derivative Instrument</u>	<u>Location on Statement of Earnings</u>	<u>Gain on Instrument</u>				<u>Loss on Hedged Item</u>			
		<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>		<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
		<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
Interest rate swaps . . . .	Interest expense, net	\$7.1	\$—	\$4.0	\$—	\$(7.1)	\$—	\$(4.0)	\$—

We had no ineffective fair value hedging instruments during the three and six month periods ended June 30, 2011 and 2010.

# ZIMMER HOLDINGS, INC. AND SUBSIDIARIES

## NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### *Derivatives Designated as Cash Flow Hedges*

Derivative instruments designated as cash flow hedges had the following effects on other comprehensive income (OCI) on our condensed consolidated balance sheet and our condensed consolidated statement of earnings (in millions):

Derivative Instrument	Amount of Gain/(Loss) Recognized in OCI				Location on Statement of Earnings	Amount of Gain/(Loss) Reclassified from OCI			
	Three Months Ended June 30,		Six Months Ended June 30,			Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010		2011	2010	2011	2010
Foreign exchange forward contracts . . . .	\$(16.0)	\$28.3	\$(74.1)	\$58.9	Cost of products sold	\$(12.2)	\$8.0	\$(17.4)	\$7.6
Foreign exchange options . . . . .	2.8	—	3.7	—	Cost of products sold	—	—	—	—
Cross-currency interest rate swaps . . . .	(0.8)	—	0.2	—	Interest expense, net	(0.5)	—	(3.5)	—
	<u>\$(14.0)</u>	<u>\$28.3</u>	<u>\$(70.2)</u>	<u>\$58.9</u>		<u>\$(12.7)</u>	<u>\$8.0</u>	<u>\$(20.9)</u>	<u>\$7.6</u>

The net amount recognized in earnings during the three and six month periods ended June 30, 2011 and 2010 due to ineffectiveness and amounts excluded from the assessment of hedge effectiveness was not significant.

The fair value of outstanding derivative instruments designated as cash flow hedges and recorded on the balance sheet at June 30, 2011, together with settled derivatives where the hedged item has not yet affected earnings, was a net unrealized loss of \$73.4 million, or \$45.0 million after taxes, which is deferred in accumulated other comprehensive income. Of the net unrealized loss, \$43.0 million, or \$28.3 million after taxes, is expected to be reclassified to earnings over the next twelve months.

### *Derivatives Not Designated as Hedging Instruments*

The following gains/(losses) from these derivative instruments were recognized on our condensed consolidated statement of earnings (in millions):

Derivative Instrument	Location on Statement of Earnings	Three Months Ended June 30,		Six Months Ended June 30,	
		2011	2010	2011	2010
Foreign exchange forward contracts . . . . .	Cost of products sold	\$1.3	\$11.1	\$(13.7)	\$18.3

This impact does not include any offsetting gains/losses recognized in earnings as a result of foreign currency remeasurement of monetary assets and liabilities denominated in a currency other than an entity's functional currency.

### **Balance Sheet Presentation**

As of June 30, 2011 and December 31, 2010, all derivative instruments designated as fair value hedges and cash flow hedges are recorded at fair value on the balance sheet. On our consolidated balance sheet, we recognize individual forward contracts and options with the same counterparty on a net asset/liability basis if we have a master

## ZIMMER HOLDINGS, INC. AND SUBSIDIARIES

### NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

netting agreement with the counterparty. The fair value of derivative instruments on a gross basis is as follows (in millions):

		June 30, 2011		December 31, 2010	
		Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
<b>Asset Derivatives</b>					
Foreign exchange forward contracts . . . . .	Other current assets		\$27.1	Other current assets	\$32.2
Foreign exchange options . . . . .	Other current assets		1.8	Other current assets	0.4
Foreign exchange forward contracts . . . . .	Other assets		5.8	Other assets	11.6
Foreign exchange options . . . . .	Other assets		4.6	Other assets	2.3
Interest rate swaps . . . . .	Other assets		5.5	Other assets	1.5
<b>Total asset derivatives . . . . .</b>			<u>\$44.8</u>		<u>\$48.0</u>
<b>Liability Derivatives</b>					
Foreign exchange forward contracts . . . . .	Other current liabilities		\$66.3	Other current liabilities	\$37.6
Cross-currency interest rate swaps . . . . .	Other current liabilities		3.3	Other current liabilities	—
Foreign exchange forward contracts . . . . .	Other long-term liabilities		28.1	Other long-term liabilities	14.4
<b>Total liability derivatives . . . . .</b>			<u>\$97.7</u>		<u>\$52.0</u>

#### 11. Income Taxes

We operate on a global basis and are subject to numerous and complex tax laws and regulations. Our income tax filings are regularly under audit in multiple federal, state and foreign jurisdictions. Income tax audits may require an extended period of time to reach resolution and may result in significant income tax adjustments when interpretation of tax laws or allocation of company profits is disputed. During the first and second quarters of 2011, we resolved tax matters in multiple jurisdictions resulting in a reduction in both the net amount of tax liability for unrecognized tax benefits and income tax expense. The net amount of tax liability for unrecognized tax benefits may change within the next twelve months due to changes in audit status, expiration of statutes of limitations and other events which could impact our determination of unrecognized tax benefits. Currently, we cannot reasonably estimate the amount by which our unrecognized tax benefits will change.

In the three and six month periods ended June 30, 2011, our effective tax rate was 18.2 percent and 22.9 percent, respectively. Our effective tax rates were lower than the U.S. statutory income tax rate of 35 percent primarily due to income earned in foreign locations with lower tax rates, the resolution of certain tax matters discussed above, and the accrual of \$50.0 million “Certain claims” expense, which lowered the U.S. tax jurisdiction income relative to the income of our foreign operations.

In May 2011, the IRS concluded their examination of our U.S. federal returns for years 2005 through 2007 and issued income tax assessments reallocating profits between certain of our U.S. and foreign subsidiaries. We believe that we have followed applicable U.S. tax laws and are vigorously defending our income tax positions. The ultimate resolution of this matter is uncertain and could have a material impact on our income tax expense, results of operations, and cash flows for future periods.

#### 12. Retirement Benefit Plans

We have defined benefit pension plans covering certain U.S. and Puerto Rico employees. The employees who are not participating in the defined benefit plans receive additional benefits under our defined contribution plans. Plan benefits are primarily based on years of credited service and the participant’s compensation. In addition to the

## ZIMMER HOLDINGS, INC. AND SUBSIDIARIES

### NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

U.S. and Puerto Rico defined benefit pension plans, we sponsor various non-U.S. pension arrangements, including retirement and termination benefit plans required by local law or coordinated with government sponsored plans.

The components of net pension expense for our U.S. and non-U.S. defined benefit retirement plans are as follows (in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Service cost. . . . .	\$ 7.2	\$ 6.2	\$ 14.1	\$ 12.5
Interest cost. . . . .	5.2	4.4	10.2	9.0
Expected return on plan assets . . . . .	(8.0)	(6.4)	(15.8)	(12.9)
Amortization of prior service cost . . . . .	(0.2)	(0.3)	(0.4)	(0.4)
Amortization of unrecognized actuarial loss . . . . .	<u>1.8</u>	<u>0.8</u>	<u>3.7</u>	<u>1.7</u>
Net periodic benefit cost . . . . .	<u>\$ 6.0</u>	<u>\$ 4.7</u>	<u>\$ 11.8</u>	<u>\$ 9.9</u>

We contributed \$36.5 million during the six month period ended June 30, 2011 to our U.S. and Puerto Rico defined benefit plans and do not expect to contribute additional funds to these plans during the remainder of 2011. We contributed \$7.9 million to our foreign-based defined benefit plans in the six month period ended June 30, 2011 and expect to contribute approximately \$8 million to these foreign-based plans during the remainder of 2011.

### 13. Earnings Per Share

The following is a reconciliation of weighted average shares for the basic and diluted shares computations (in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Weighted average shares outstanding for basic net earnings per share. . . . .	191.5	201.9	192.1	202.4
Effect of dilutive stock options and other equity awards . . . . .	<u>1.2</u>	<u>1.1</u>	<u>1.2</u>	<u>1.2</u>
Weighted average shares outstanding for diluted net earnings per share. . . . .	<u>192.7</u>	<u>203.0</u>	<u>193.3</u>	<u>203.6</u>

During the three and six month periods ended June 30, 2011, an average of 11.6 million options and 12.2 million options, respectively, to purchase shares of common stock were not included in the computation of diluted earnings per share because the exercise prices of these options were greater than the average market price of the common stock. During the three and six month periods ended June 30, 2010, an average of 13.3 million options and 13.1 million options, respectively, were not included in the computation.

In the three month period ended June 30, 2011, we repurchased 1.8 million shares of our common stock at an average price of \$66.21 per share for a total cash outlay of \$121.1 million, including commissions. In the six month period ended June 30, 2011, we repurchased 6.1 million shares of our common stock at an average price of \$58.97 per share for a total cash outlay of \$357.2 million, including commissions. As of June 30, 2011, approximately \$0.8 billion remained authorized under a \$1.5 billion repurchase program, which will expire on December 31, 2013.



# ZIMMER HOLDINGS, INC. AND SUBSIDIARIES

## NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### 14. Segment Information

We design, develop, manufacture and market orthopaedic reconstructive implants, dental implants, spinal implants, trauma products and related surgical products which include surgical supplies and instruments designed to aid in surgical procedures and post-operation rehabilitation. We also provide other healthcare-related services which generate revenues that are less than 1 percent of our total net sales. We manage operations through three major geographic segments — the Americas, which is comprised principally of the U.S. and includes other North, Central and South American markets; Europe, which is comprised principally of Europe and includes the Middle East and African markets; and Asia Pacific, which is comprised primarily of Japan and includes other Asian and Pacific markets. This structure is the basis for our reportable segment information discussed below. Management evaluates reportable segment performance based upon segment operating profit exclusive of operating expenses pertaining to share-based payment expense, inventory step-up, “Certain claims,” goodwill impairment, “Special items” and global operations and corporate functions. Global operations and corporate functions include research, development engineering, medical education, brand management, corporate legal, finance, and human resource functions, U.S. and Puerto Rico-based manufacturing operations and logistics and intangible amortization resulting from business combination accounting. Intercompany transactions have been eliminated from segment operating profit.

Net sales and segment operating profit are as follows (in millions):

	Net Sales		Operating Profit	
	Three Months Ended June 30,		Three Months Ended June 30,	
	2011	2010	2011	2010
Americas . . . . .	\$ 608.6	\$ 609.3	\$ 302.0	\$ 307.5
Europe . . . . .	324.7	276.5	105.4	101.8
Asia Pacific . . . . .	204.1	171.9	73.1	65.7
Total . . . . .	<u>\$1,137.4</u>	<u>\$1,057.7</u>		
Share-based compensation . . . . .			(17.4)	(17.9)
Inventory step-up . . . . .			(3.4)	—
Certain Claims . . . . .			(50.0)	(75.0)
Special items . . . . .			(13.5)	(11.5)
Global operations and corporate functions . . . . .			<u>(137.1)</u>	<u>(142.5)</u>
Operating profit . . . . .			<u>\$ 259.1</u>	<u>\$ 228.1</u>

# ZIMMER HOLDINGS, INC. AND SUBSIDIARIES

## NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

	Net Sales		Operating Profit	
	Six Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Americas . . . . .	\$1,238.3	\$1,225.0	\$ 613.4	\$ 614.3
Europe . . . . .	623.9	562.6	216.2	206.6
Asia Pacific . . . . .	390.8	332.9	147.0	126.8
Total . . . . .	<u>\$2,253.0</u>	<u>\$2,120.5</u>		
Share-based compensation . . . . .			(31.7)	(30.6)
Inventory step-up . . . . .			(7.8)	(1.3)
Certain Claims . . . . .			(50.0)	(75.0)
Special items . . . . .			(39.0)	(14.1)
Global operations and corporate functions . . . . .			<u>(291.8)</u>	<u>(304.5)</u>
Operating profit . . . . .			<u>\$ 556.3</u>	<u>\$ 522.2</u>

Net sales by product category are as follows (in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Reconstructive				
Knees . . . . .	\$ 470.9	\$ 452.9	\$ 933.1	\$ 913.3
Hips . . . . .	345.0	317.1	682.3	632.8
Extremities . . . . .	40.7	38.2	83.6	76.6
Total . . . . .	<u>856.6</u>	<u>808.2</u>	<u>1,699.0</u>	<u>1,622.7</u>
Dental . . . . .	67.1	55.9	129.5	107.6
Trauma . . . . .	69.1	57.8	139.2	118.2
Spine . . . . .	56.4	57.9	113.3	117.9
Surgical and other . . . . .	88.2	77.9	172.0	154.1
Total . . . . .	<u>\$1,137.4</u>	<u>\$1,057.7</u>	<u>\$2,253.0</u>	<u>\$2,120.5</u>

## 15. Commitments and Contingencies

### Product Liability and Related Claims

We are subject to product liability claims arising in the ordinary course of our business. We establish standard accruals for product liability claims in conjunction with outside counsel based on current information and historical settlement information for open claims, related legal fees and claims incurred but not reported. These standard product liability accruals are recognized in selling, general and administrative expense. We may also establish provisions for certain product liability claims outside of the standard accruals that are recorded separately on our statement of earnings, such as the provision for claims related to the *Durom*® Acetabular Component (*Durom* Cup) discussed below. We maintain insurance, subject to self-insured retention requirements, for losses from these and other claims.

## ZIMMER HOLDINGS, INC. AND SUBSIDIARIES

### NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

On July 22, 2008, we temporarily suspended marketing and distribution of the *Durom* Cup in the U.S. Subsequently, a number of product liability lawsuits and other claims have been asserted against us. We have settled some of these claims and the others are still pending. Additional claims may be asserted in the future.

We have recorded provisions totaling \$229.0 million as “Certain claims” on our statement of earnings, including \$50.0 million and \$75.0 million in the three month periods ending June 30, 2011 and 2010, respectively, representing our estimate of the *Durom* Cup-related claims we expect to be made for revision surgeries. Initially, the “Certain claims” provision was limited to original surgeries performed before July 22, 2008, with a revision surgery occurring within two years of the original surgery. However, based upon subsequent claims received we revised our estimate to include all claims for original surgeries performed before July 22, 2008 on a worldwide basis, regardless of the amount of time between the revision surgery and the original surgery. We have received claims in excess of our previous estimates, which necessitated the additional \$50.0 million provision in the three month period ended June 30, 2011.

From 2008 through March 31, 2010, we recorded \$42.7 million as part of our standard product liability accruals for worldwide claims relating to revisions of *Durom* Cup cases where the revisions had occurred, or were estimated to occur, more than two years after the original surgery. Of this amount, \$10.9 million was recorded in the three month period ended March 31, 2010. Beginning with the second quarter of 2010, any additional provisions for such claims are recorded as part of the “Certain claims” accrual, as described above.

We will continue to record any provisions for claims relating to *Durom* Cup cases where the original surgery was performed after July 22, 2008 as part of our standard product liability accruals. As of June 30, 2011, we have recorded cumulative provisions totaling \$9.0 million for such post-suspension claims.

Our estimate as of June 30, 2011 of the remaining liability for all *Durom* Cup-related claims relating to original surgeries performed before July 22, 2008 is \$159.8 million, of which \$42.5 million is classified as short-term in “Other current liabilities” and \$117.3 million is classified as long-term in “Other long-term liabilities” on our consolidated balance sheet. We expect to pay the majority of the *Durom* Cup-related claims within the next three years.

We rely on significant estimates in determining the provisions for *Durom* Cup-related claims, including the number of claims that we will receive and the average amount we will pay per claim. The actual number of claims that we receive and the amount we pay per claim may differ from our estimates. We cannot reasonably estimate the possible loss or range of loss that may result from *Durom* Cup-related claims in excess of the losses we have accrued.

On August 20, 2008, Margo and Daniel Polett filed an action against us and an unrelated third party, Public Communications, Inc. (PCI), in the Court of Common Pleas, Philadelphia, Pennsylvania seeking an unspecified amount of damages for injuries and loss of consortium allegedly suffered by Mrs. Polett and her spouse, respectively. The complaint alleged that defendants were negligent in connection with Mrs. Polett’s participation in a promotional video featuring one of our knee products. The case was tried in November 2010 and the jury returned a verdict in favor of plaintiffs. The jury awarded \$27.6 million in compensatory damages and apportioned fault 30 percent to plaintiffs, 34 percent to us and 36 percent to PCI. Under applicable law, we may be liable for any portion of the damages apportioned to PCI that it does not pay. On December 2, 2010, we and PCI filed a Motion for Post-Trial Relief seeking a judgment notwithstanding the verdict, a new trial or a remittitur. On June 10, 2011, the trial court entered an order denying our Motion for Post-Trial Relief and affirming the jury verdict in full and entered judgment for \$20.3 million against us and PCI. On June 29, 2011, we filed a Notice of Appeal to the Superior Court of Pennsylvania and posted a bond for the verdict amount plus interest. We do not believe the facts and evidence support the jury’s verdict. We have not recorded any charge relating to this matter in our condensed consolidated statement of earnings for the quarter ended June 30, 2011 or for any prior period, because we believe we have strong arguments for reversing the jury verdict on appeal. As a result, we do not believe that it is probable that we have incurred a liability consistent with the verdict and we cannot reasonably estimate any loss that might eventually be incurred. Although we believe we have strong grounds to reverse the jury’s verdict, the ultimate resolution of this matter is uncertain. We could in the future be required to record a charge to our consolidated statement of earnings that could have a material adverse effect on our results of operations in any particular period.

## **ZIMMER HOLDINGS, INC. AND SUBSIDIARIES**

### **NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

#### **Intellectual Property and Related Claims**

We are subject to claims of patent infringement and other intellectual property-related claims and lawsuits in the ordinary course of our business.

On February 15, 2005, Howmedica Osteonics Corp. filed an action against us and an unrelated party in the U.S. District Court for the District of New Jersey alleging infringement of U.S. Patent Nos. 6,174,934; 6,372,814; 6,664,308; and 6,818,020. On June 13, 2007, the Court granted our motion for summary judgment on the invalidity of the asserted claims of U.S. Patent Nos. 6,174,934; 6,372,814; and 6,664,308 by ruling that all of the asserted claims are invalid for indefiniteness. On August 19, 2008, the Court granted our motion for summary judgment of non-infringement of certain claims of U.S. Patent No. 6,818,020, reducing the number of claims at issue in the suit to five. On April 9, 2009, in response to our earlier petition, the U.S. Patent and Trademark Office (USPTO) instituted re-examination proceedings against U.S. Patent No. 6,818,020. The USPTO rejected all previously issued claims of U.S. Patent No. 6,818,020 as being unpatentable in light of one or more prior art references. On September 30, 2009, the Court issued an order staying proceedings in the litigation pending the outcome of the re-examination process. Subsequent to that stay order, Howmedica filed a motion seeking to certify an appeal of the summary judgment ruling on the '934, '814 and '308 patents. That motion was granted on January 13, 2010. On October 13, 2010, the U.S. Court of Appeals for the Federal Circuit affirmed the District Court's ruling on the invalidity of the asserted claims of the '934, '814 and '308 patents. On November 12, 2010, Howmedica filed a petition for a re-hearing en banc, which was denied on December 14, 2010. On March 14, 2011, Howmedica filed a Petition for Writ of Certiorari in the U.S. Supreme Court seeking review of the Federal Circuit decision, which was denied on May 16, 2011. The case otherwise remains stayed pending the USPTO's re-examination of the '020 patent. We continue to believe that our defenses against infringement of the '020 patent are valid and meritorious, and we intend to continue to defend this lawsuit vigorously.

We are involved in certain ongoing contractual and other disputes pertaining to royalty arrangements with licensors of technology. We intend to defend ourselves vigorously against the licensors' claims. Because these matters are in the preliminary stages of the dispute resolution process, we cannot estimate the possible loss, if any, we may incur or predict the likely outcome of these matters.

#### **Government Investigations**

In September 2007, we and other orthopaedic companies settled a U.S. government investigation pertaining to consulting contracts, professional services agreements and other agreements by which remuneration is provided to orthopaedic surgeons. As part of the settlement, we entered into a Corporate Integrity Agreement (CIA) with the Office of Inspector General of the Department of Health and Human Services (OIG-HHS). Under the CIA, which has a term expiring in 2012, we agreed, among other provisions, to continue the operation of our enhanced Corporate Compliance Program, designed to promote compliance with federal healthcare program requirements. We also agreed to retain an independent review organization to perform annual reviews to assist us in assessing our compliance with the obligations set forth in the CIA to ensure that arrangements we enter into do not violate the Anti-Kickback Statute (42 U.S.C. § 1320a-7b). A material breach of the CIA may subject us to exclusion by OIG-HHS from participation in all federal healthcare programs, which would have a material adverse effect on our financial position, results of operations and cash flows.

In September 2007, the Staff of the U.S. Securities and Exchange Commission (SEC) informed us that it was conducting an investigation regarding potential violations of the Foreign Corrupt Practices Act (FCPA) in the sale of medical devices in a number of foreign countries by companies in the medical device industry. In November 2007, we received a letter from the U.S. Department of Justice (DOJ) requesting that any information provided to the SEC also be provided to the DOJ on a voluntary basis. In the course of continuing dialogues with the agencies, we have voluntarily disclosed information to the SEC and DOJ relating to sales of our products by independent distributors in two South American countries. In the first quarter of 2011, we received a subpoena from the SEC seeking documents and other records pertaining to our business activities in substantially all countries in the Asia Pacific

## ZIMMER HOLDINGS, INC. AND SUBSIDIARIES

### NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

region where we operate. We are in the process of responding to the subpoena. We cannot currently predict the outcome of this investigation.

#### Putative Class Actions

On August 5, 2008, a complaint was filed in the U.S. District Court for the Southern District of Indiana, *Plumbers and Pipefitters Local Union 719 Pension Fund v. Zimmer Holdings, Inc., et al.*, naming us and two of our executive officers as defendants. The complaint related to a putative class action on behalf of persons who purchased our common stock between January 29, 2008 and July 22, 2008. The complaint alleged that the defendants violated the federal securities law by allegedly failing to disclose developments relating to our orthopaedic surgical products manufacturing operations in Dover, Ohio and the *Durom* Cup. The plaintiff sought unspecified damages and interest, attorneys' fees, costs and other relief. On December 24, 2008, the lead plaintiff filed a consolidated complaint that alleged the same claims and related to the same time period. The defendants filed a motion to dismiss the consolidated complaint on February 23, 2009. On December 1, 2009, the Court granted defendants' motion to dismiss, without prejudice. On January 15, 2010, the plaintiff filed a motion for leave to amend the consolidated complaint. On January 28, 2011, the Court denied the plaintiff's motion for leave to amend the consolidated complaint and dismissed the case. On February 25, 2011, the plaintiff filed a notice of appeal to the U.S. Court of Appeals for the Seventh Circuit. We believe this lawsuit is without merit, and we and the individual defendants intend to defend it vigorously.

On November 20, 2008, a complaint was filed in the U.S. District Court for the Northern District of Indiana, *Dewald v. Zimmer Holdings, Inc., et al.*, naming us and certain of our current and former directors and employees as defendants. The complaint relates to a putative class action on behalf of all persons who were participants in or beneficiaries of our U.S. or Puerto Rico Savings and Investment Programs (plans) between October 5, 2007 and the date of filing and whose accounts included investments in our common stock. The complaint alleges, among other things, that the defendants breached their fiduciary duties in violation of the Employee Retirement Income Security Act of 1974, as amended, by continuing to offer Zimmer stock as an investment option in the plans when the stock purportedly was no longer a prudent investment and that defendants failed to provide plan participants with complete and accurate information sufficient to advise them of the risks of investing their retirement savings in Zimmer stock. The plaintiff seeks an unspecified monetary payment to the plans, injunctive and equitable relief, attorneys' fees, costs and other relief. On January 23, 2009, the plaintiff filed an amended complaint that alleges the same claims and clarifies that the class period is October 5, 2007 through September 2, 2008. The defendants filed a motion to dismiss the amended complaint on March 23, 2009. The motion to dismiss is pending with the court. On June 12, 2009, the U.S. Judicial Panel on Multidistrict Litigation entered an order transferring the Dewald case to the U.S. District Court for the Southern District of Indiana for coordinated or consolidated pretrial proceedings with the Plumbers & Pipefitters Local Union 719 Pension Fund case referenced above. We believe this lawsuit is without merit, and we and the individual defendants intend to defend it vigorously.

## **Item 2. *Management's Discussion and Analysis of Financial Condition and Results of Operations***

The following discussion and analysis should be read in conjunction with the condensed consolidated financial statements and corresponding notes included elsewhere in this Form 10-Q. Certain percentages presented in this discussion and analysis are calculated from the underlying whole-dollar amounts and therefore may not recalculate from the rounded numbers used for disclosure purposes. In addition, certain amounts in the 2010 condensed consolidated financial statements have been reclassified to conform to the 2011 presentation.

### **Overview**

We believe the following developments or trends are important in understanding our financial condition, results of operations and cash flows for the three and six month periods ended June 30, 2011 and our expected results for the remainder of 2011.

#### **Demand (Volume and Mix) Trends**

Increased volume and changes in the mix of product sales contributed 3 percentage points of year-over-year sales growth during the three month period ended June 30, 2011, which is 1 percentage point less than the three month period ended June 30, 2010, as well as the three month period ended March 31, 2011.

Volume and mix trends continued to be challenged by the global economy, especially in our Americas operating segment. We believe continued high unemployment levels are linked to lower enrollment in private health insurance plans, which has affected the patient pool for joint replacement procedures.

Long-term indicators still point toward sustained growth driven by an aging global population, obesity, more active lifestyles, growth in emerging markets, new material technologies, advances in surgical techniques and proven clinical benefits of joint replacement procedures. In addition, the ongoing shift in demand to premium products, such as *Prolong*® Highly Crosslinked Polyethylene, *Trabecular Metal*™ Technology products, hip stems with *Kinectiv*® Technology, high-flex knees, porous hip stems and the introduction of patient specific devices, is expected to continue to positively affect sales growth.

#### **Pricing Trends**

Global selling prices had a negative effect of 1 percent on year-over-year sales growth during the three month period ended June 30, 2011, which is consistent with the three month period ended June 30, 2010, as well as the three month period ended March 31, 2011. Selling prices in the Americas had a negative effect of 1 percent on sales growth in that operating segment during the three month period ended June 30, 2011. Europe selling prices had minimal effects on sales growth in that operating segment during the three month period ended June 30, 2011. In our Asia Pacific operating segment, the pricing trends improved from a negative 3 percent effect on year-over-year sales growth in the three month period ended March 31, 2011, to a negative 1 percent effect in the three month period ended June 30, 2011. This is mainly attributable to the anniversary of bi-annual pricing adjustments in Japan that went into effect on April 1, 2010. Accordingly, we expect pricing trends consistent with the three month period ended June 30, 2011 for the rest of the year in the Asia Pacific operating segment. We now expect selling prices will be down approximately 1 percent on a global basis for 2011 largely due to governmental healthcare cost containment efforts and continuing pricing pressure from local hospitals and health systems.

#### **Foreign Currency Exchange Rates**

For the three month period ended June 30, 2011, foreign currency exchange rates resulted in a 6 percent increase in sales. Assuming currency rates remain at June 30, 2011 rates, for the year ending December 31, 2011, we estimate that an overall weaker U.S. Dollar versus foreign currency exchange rates will have a positive effect of approximately 3 percent on sales. We seek to mitigate currency risk through regular operating and financing activities and, under appropriate circumstances and subject to proper authorization, through the use of forward contracts and foreign currency options solely for managing foreign currency volatility and risk. Changes to foreign currency exchange rates affect sales growth, but due to offsetting gains/losses on hedge contracts, which are recorded in cost of products sold, the effect on net earnings in the near term is expected to be minimal.



## 2011 Outlook

We estimate our sales will grow between 5.5 and 6.5 percent for the full year in 2011. Such sales growth assumes the market for global knee and hip procedures will be flat to slightly positive. As discussed previously, we expect pricing to have a negative effect on sales growth of approximately 1 percent, and foreign currency exchange rates to have a positive effect on sales growth of approximately 3 percent based upon June 30, 2011 rates.

Assuming currencies remain at June 30, 2011 rates, we expect our gross margin to be approximately 75 percent of sales in 2011. This takes into account anticipated losses from foreign currency hedge contracts resulting from relative weakness in the U.S. Dollar. We expect to continue making investments in research and development (R&D) in the range of 5 to 5.5 percent of sales. Selling, general and administrative expenses (SG&A) as a percent of sales is expected to be approximately 41 percent as we continue to invest to further build out our global sales channels and realize a higher mix of revenues from overseas markets.

We expect to incur \$75 to \$80 million of expenses in 2011 related to ongoing global restructuring and transformation initiatives. We also expect to incur an additional \$15 to \$20 million for certain integration costs connected with recent acquisitions. We anticipate recognizing some of the \$90 to \$100 million in cost of products sold and the majority in “Special items” on our statement of net earnings. The gross margin and SG&A percentages discussed above do not include these expenses.

## **RESULTS OF OPERATIONS**

### *Net Sales by Operating Segment*

The following tables present net sales by operating segment and the components of the percentage changes (dollars in millions):

	<b>Three Months Ended June 30,</b>		<b>% Inc</b>	<b>Volume/ Mix</b>	<b>Price</b>	<b>Foreign Exchange</b>
	<b>2011</b>	<b>2010</b>				
Americas . . . . .	\$ 608.6	\$ 609.3	—%	1%	(1) %	—%
Europe . . . . .	324.7	276.5	17	5	—	12
Asia Pacific . . . . .	204.1	171.9	19	7	(1)	13
Total . . . . .	<u>\$1,137.4</u>	<u>\$1,057.7</u>	8	3	(1)	6

“Foreign Exchange” as used in the tables in this report represents the effect of changes in foreign currency exchange rates on sales growth.

	<b>Six Months Ended June 30,</b>		<b>% Inc</b>	<b>Volume/ Mix</b>	<b>Price</b>	<b>Foreign Exchange</b>
	<b>2011</b>	<b>2010</b>				
Americas . . . . .	\$1,238.3	\$1,225.0	1%	2%	(1) %	—%
Europe . . . . .	623.9	562.6	11	4	1	6
Asia Pacific . . . . .	390.8	332.9	17	9	(2)	10
Total . . . . .	<u>\$2,253.0</u>	<u>\$2,120.5</u>	6	4	(1)	3

### *Net Sales by Product Category*

The following tables present net sales by product category and the components of the percentage changes (dollars in millions):

	Three Months Ended June 30,		% Inc (Dec)	Volume/ Mix	Price	Foreign Exchange
	2011	2010				
<u>Reconstructive</u>						
Knees . . . . .	\$ 470.9	\$ 452.9	4%	1%	(2) %	5%
Hips . . . . .	345.0	317.1	9	4	(2)	7
Extremities . . . . .	<u>40.7</u>	<u>38.2</u>	7	5	(1)	3
Total . . . . .	<u>856.6</u>	<u>808.2</u>	6	2	(2)	6
Dental . . . . .	67.1	55.9	20	8	8	4
Trauma . . . . .	69.1	57.8	20	12	2	6
Spine . . . . .	56.4	57.9	(3)	(5)	(1)	3
Surgical and other . . . . .	<u>88.2</u>	<u>77.9</u>	13	8	—	5
Total . . . . .	<u>\$1,137.4</u>	<u>\$1,057.7</u>	8	3	(1)	6

	Six Months Ended June 30,		% Inc (Dec)	Volume/ Mix	Price	Foreign Exchange
	2011	2010				
<u>Reconstructive</u>						
Knees . . . . .	\$ 933.1	\$ 913.3	2%	1%	(2) %	3%
Hips . . . . .	682.3	632.8	8	5	(2)	5
Extremities . . . . .	83.6	76.6	9	8	(1)	2
Total . . . . .	<u>1,699.0</u>	<u>1,622.7</u>	5	3	(2)	4
Dental . . . . .	129.5	107.6	20	9	9	2
Trauma . . . . .	139.2	118.2	18	13	1	4
Spine . . . . .	113.3	117.9	(4)	(4)	(2)	2
Surgical and other . . . . .	172.0	154.1	12	7	—	5
Total . . . . .	<u>\$2,253.0</u>	<u>\$2,120.5</u>	6	4	(1)	3



The following table presents net sales by product category by region (dollars in millions):

	Three Months Ended June 30,			Six Months Ended June 30,		
	2011	2010	% Inc (Dec)	2011	2010	% Inc (Dec)
<b>Reconstructive</b>						
Knees						
<i>Americas</i> . . . . .	\$ 266.5	\$ 279.8	(5) %	\$ 544.3	\$ 566.0	(4) %
<i>Europe</i> . . . . .	127.9	106.1	21	245.1	219.7	12
<i>Asia Pacific</i> . . . . .	76.5	67.0	14	143.7	127.6	13
Hips						
<i>Americas</i> . . . . .	151.4	148.4	2	306.0	295.2	4
<i>Europe</i> . . . . .	121.8	109.2	12	236.0	221.0	7
<i>Asia Pacific</i> . . . . .	71.8	59.5	20	140.3	116.6	20
Extremities						
<i>Americas</i> . . . . .	31.1	29.6	5	64.3	59.2	9
<i>Europe</i> . . . . .	6.9	6.2	10	13.7	12.7	8
<i>Asia Pacific</i> . . . . .	<u>2.7</u>	<u>2.4</u>	14	<u>5.6</u>	<u>4.7</u>	20
Total . . . . .	<u>856.6</u>	<u>808.2</u>	6	<u>1,699.0</u>	<u>1,622.7</u>	5
Dental						
<i>Americas</i> . . . . .	33.6	28.5	18	68.3	55.7	23
<i>Europe</i> . . . . .	25.0	21.4	16	45.7	40.2	13
<i>Asia Pacific</i> . . . . .	8.5	6.0	44	15.5	11.7	33
Trauma						
<i>Americas</i> . . . . .	35.1	31.3	12	72.1	63.9	13
<i>Europe</i> . . . . .	15.9	11.2	43	30.0	23.0	31
<i>Asia Pacific</i> . . . . .	18.1	15.3	19	37.1	31.3	18
Spine						
<i>Americas</i> . . . . .	37.3	41.7	(11)	76.1	85.7	(11)
<i>Europe</i> . . . . .	14.4	12.6	15	28.2	25.5	11
<i>Asia Pacific</i> . . . . .	4.7	3.6	29	9.0	6.7	34
Surgical and other						
<i>Americas</i> . . . . .	53.6	50.0	7	107.2	99.3	8
<i>Europe</i> . . . . .	12.8	9.8	32	25.2	20.5	23
<i>Asia Pacific</i> . . . . .	<u>21.8</u>	<u>18.1</u>	20	<u>39.6</u>	<u>34.3</u>	15
Total . . . . .	<u>\$1,137.4</u>	<u>\$1,057.7</u>	8	<u>\$2,253.0</u>	<u>\$2,120.5</u>	6

### ***Knees***

Knee sales increased 4 percent and 2 percent in the three and six month periods ended June 30, 2011, respectively, when compared to the same prior year periods. We estimate that industry procedure volumes were likely flat to slightly positive on a global basis in the first half of 2011 while pricing was negative. While year-over-year comparisons ease in the second half of 2011, we believe procedure volumes will continue to be pressured from a cyclical downturn related to unemployment levels.

The NexGen® Complete Knee Solution product line, including *Gender Solutions*® Knee Femoral Implants, the NexGen LPS-Flex Knee and the NexGen CR-Flex Knee, together with the *Gender Solutions Natural-Knee*® Flex System, led knee sales. In addition, sales of the *Gender Solutions* Patello Femoral Joint and Zimmer® Patient Specific Instruments exhibited growth. In Europe, we completed a large tender contract to the ministry of health in a

government-run healthcare system in the three month period ended June 30, 2011, which contributed to knee sales growth in that operating segment. Additionally in Europe, changes in foreign currency exchange rates positively affected knee sales by 12 percent and 6 percent in the three and six month periods ended June 30, 2011, respectively. In Asia Pacific, changes in foreign currency exchange rates positively affected knee sales by 12 percent and 11 percent in the three and six month periods ended June 30, 2011, respectively.

### ***Hips***

Hip sales increased 9 percent and 8 percent in the three and six month periods ended June 30, 2011, respectively, when compared to the same prior year periods. The increase was driven primarily by our *Continuum*® Acetabular System and our *Zimmer M/L Taper Stem with Kinectiv Technology*. Additionally, negative publicity in the marketplace over the use of hip systems that use metal-on-metal technology may have contributed to an increase in sales of hip systems with alternative bearing surfaces. Metal-on-metal technology represents only a small portion of our hip sales. Therefore, our market share position may have benefited from customers using our hip systems instead of a competitor's metal-on-metal system.

The *Zimmer M/L Taper Stem*, the *Zimmer M/L Taper Stem with Kinectiv Technology*, the *CLS*® *Spotorno*® Stem from the *CLS Hip System* and the *Alloclassic*® *Zweymüller*® Hip Stem led hip stem sales. In addition, sales of the *Continuum Acetabular System*, *Trilogy*® IT Acetabular System and *Allofit*® IT *Alloclassic Acetabular System* and the *Trabecular Metal Revision Shell and Augment Cups* were strong when compared to the prior year periods, as were sales of *BIOLOX*®<sup>1</sup> *delta Heads* and *Fitmore*® Hip Stems. In Europe, changes in foreign currency exchange rates positively affected hip sales by 13 percent and 7 percent in the three and six month periods ended June 30, 2011, respectively. In Asia Pacific, our December 2010 acquisition of Beijing Montagne Medical Device Co., Ltd. made a contribution to that operating segment's sales growth in the three and six month periods ended June 30, 2011. Additionally, in Asia Pacific changes in foreign currency exchange rates positively affected hip sales by 13 percent and 11 percent in the three and six month periods ended June 30, 2011, respectively.

### ***Extremities***

Extremities sales increased by 7 percent and 9 percent in the three and six month periods ended June 30, 2011, respectively, when compared to the same prior year periods. The *Bigliani/Flatow*® Complete Shoulder Solution and the *Zimmer Trabecular Metal Reverse Shoulder System* led extremities sales. We continue to see competitive pressure in this category, but expect that new product introductions will help to accelerate growth.

### ***Dental***

Dental sales increased by 20 percent in the three and six month periods ended June 30, 2011 when compared to the same prior year periods, including increases of 8 percent and 9 percent, respectively, due to pricing. A significant portion of this pricing increase was due to a change in the agreement by which we distribute certain regenerative products. Under the prior agreement we did not take title to the products and only received a commission from the end-user sale. Under the new agreement, we take title to the product and recognize the final end-user sale along with the cost of products sold and any other selling-related costs. Sales were led by the *Tapered Screw-Vent*® Implant System.

### ***Trauma***

Trauma sales increased 20 percent and 18 percent in the three and six month periods ended June 30, 2011, respectively, when compared to the same prior year periods. We have continued the launch of the *Zimmer Natural Nail*® System, which has significantly increased sales. In addition to the *Zimmer Natural Nail System*, *Zimmer Periarticular Locking Plates* and the *Zimmer NCB*® Plating System led trauma sales, while sales of cable products also made a strong contribution.

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<sup>1</sup> *BIOLOX*® is a trademark of CeramTec AG

## Spine

Spine sales decreased 3 percent and 4 percent in the three and six month periods ended June 30, 2011, respectively, when compared to the same prior year periods. Our spine business in the Americas operating segment continued to experience operational challenges, a difficult reimbursement landscape and challenges related to the *Dynesys*® Dynamic Stabilization System. Solid sales of the *PathFinder*® and *Sequoia*® Pedicle Screw Systems, our *Universal Clamp*™ System and *Trabecular Metal* Technology products partly offset a decline in sales of the *Dynesys* System.

## Surgical and other

Surgical sales increased 13 percent and 12 percent in the three and six month periods ended June 30, 2011, respectively, when compared to the same prior year periods. Surgical sales were led by *PALACOS*®<sup>2</sup> Bone Cement and tourniquet products. Our wound debridement products also made a strong contribution to sales results, as did our December 2010 acquisition of Sodem Diffusion S.A.

## Expenses as a Percent of Net Sales

	Three Months Ended June 30,			Six Months Ended June 30,		
	2011	2010	Inc (Dec)	2011	2010	Inc (Dec)
Cost of products sold . . . . .	25.3%	23.7%	1.6	25.2%	24.5%	0.7
Research and development . . . . .	5.0	5.1	(0.1)	5.0	4.9	0.1
Selling, general and administrative . . . . .	41.3	41.4	(0.1)	41.2	41.8	(0.6)
Certain claims . . . . .	4.4	7.1	(2.7)	2.2	3.5	(1.3)
Special items . . . . .	1.2	1.1	0.1	1.7	0.7	1.0
Operating profit . . . . .	22.8	21.6	1.2	24.7	24.6	0.1

## Cost of Products Sold

The increase in cost of products sold as a percentage of net sales for the three month period ended June 30, 2011 compared to the same prior year period is primarily due to foreign currency hedge losses recorded in the current year period compared to foreign currency hedge gains recorded in the prior year period. Under our hedging program, for derivatives which qualify as hedges of future cash flows, the effective portion of changes in fair value is temporarily recorded in other comprehensive income and then recognized in cost of products sold when the hedged item affects earnings. Additionally, the average cost per unit was higher in the current year period than the prior year period, but this was partially offset by lower excess and obsolescence charges from some product specific matters and lower royalty expense.

The increase in cost of products sold as a percentage of net sales for the six month period ended June 30, 2011 compared to the same prior year period is primarily due to foreign currency losses recorded in the current year period compared to foreign currency hedge gains recorded in the prior year period. This was partially offset by lower royalty expense.

## Operating Expenses

R&D expenses increased in both the three and six month periods ended June 30, 2011, when compared to the same prior year periods, while R&D as a percent of sales stayed relatively stable when comparing the same periods. The expense increase is in line with our strategy to focus more investment into new product development activities across nearly all of our product categories as well as to increase spending on external research, clinical, regulatory and quality initiatives. We expect R&D spending in 2011 to be 5 to 5.5 percent of sales for the full year.

<sup>2</sup> *PALACOS*® is a trademark of Heraeus Kulzer GmbH

SG&A expenses increased in dollar terms in the three and six month periods ended June 30, 2011, but have decreased as a percent of sales when compared to the same prior year periods. The dollar increases in both the three and six month periods are primarily from variable selling and distribution expenses resulting from higher net sales in the 2011 periods compared to the 2010 periods, increased intangible amortization from our December 2010 acquisitions and other intangible asset investments, and higher medical education expenses as we continue to expand training and education on the safe and effective use of our products.

In the three month period ended June 30, 2011, SG&A as a percent of sales was only slightly lower than the same prior year period as savings from certain cost savings initiatives have been reinvested in sales channels in emerging and other key markets and a higher mix of revenues in overseas markets.

In the six month period ended June 30, 2011, SG&A as a percent of sales decreased by 60 basis points for similar reasons as the three month period in addition to lower product liability costs. See Note 15 to the condensed consolidated financial statements for a more complete discussion of product liability claims.

“Certain claims” expense is a provision for estimated liabilities to *Durom* Cup patients undergoing revision surgeries. A provision of \$104.0 million was originally recorded during 2008 and 2009 with an additional \$50.0 million and \$75.0 million recorded during the three month periods ended June 30, 2011 and 2010, respectively, bringing the total provision to \$229.0 million for these claims. For more information regarding these claims, see Note 15 to the condensed consolidated financial statements.

“Special items” for the three and six month periods ended June 30, 2011 increased to \$13.5 million and \$39.0 million, respectively, from \$11.5 million and \$14.1 million in the same prior year periods, respectively. The largest component of “Special items” in 2011 was employee severance and termination-related expenses resulting from a reduction in management layers, expansion of management spans of control, and changes in our organizational structure. “Special items” also includes expenses relating to integration of business acquisitions and fixed asset impairments. The 2010 expenses were primarily related to expenses resulting from business acquisitions. See Note 2 to the condensed consolidated financial statements for more information regarding “Special items” charges.

### ***Interest Expense, Income Taxes and Net Earnings***

Interest expense, net for the three and six month periods ended June 30, 2011 decreased to \$9.8 million and \$20.8 million, respectively, from \$14.3 million and \$28.9 million in the same prior year periods, respectively. The decrease in interest expense is the result of interest rate swap agreements we entered into in late 2010 and early 2011 to convert fixed-rate debt into variable-rate debt. Additionally, interest income has increased due to higher balances of cash and cash equivalents and short-term and long-term investments and higher returns on certain investments.

The effective tax rate on earnings before income taxes for the three and six month periods ended June 30, 2011 decreased to 18.2 percent and 22.9 percent, respectively, from 22.6 percent and 24.8 percent in the same prior year periods, respectively. The effective tax rates in the 2011 periods were positively affected by the favorable resolution of certain tax matters and the tax effect of the “Certain claims” provision. The effective tax rates in the 2010 periods were positively affected by the “Certain claims” provision. We anticipate the outcome of various federal, state and foreign audits as well as expiration of certain statutes of limitations could potentially impact our 2011 effective tax rate in future quarters. Currently, we cannot reasonably estimate the impact of these items on our financial results.

Net earnings increased 23 percent to \$203.8 million for the three month period ended June 30, 2011, compared to \$165.5 million in the same prior year period. Net earnings increased 11 percent to \$412.7 million for the six month period ended June 30, 2011, compared to \$370.9 million in the same prior year period. The improvements in net earnings were due to the changes in revenues and expenses discussed above. For the three month period ended June 30, 2011, basic and diluted earnings per share both increased 29 percent to \$1.06 from \$0.82 in the same prior year period. For the six month period ended June 30, 2011, basic and diluted earnings per share both increased 18 percent to \$2.15 and \$2.14, respectively, from \$1.83 and \$1.82, respectively, in the same prior year period. The disproportional change in earnings per share as compared with net earnings is attributed to the effect of 2011 and 2010 share repurchases.

### *Non-GAAP operating performance measures*

We use non-GAAP financial measures to evaluate our operating performance that differ from financial measures determined in accordance with U.S. GAAP. Our non-GAAP financial measures exclude the impact of inventory step-up charges, “Certain claims” and “Special items,” and the taxes on those items in addition to certain other tax adjustments. We use this information internally and believe it is helpful to investors because it allows more meaningful period-to-period comparisons of our ongoing operating results, it helps to perform trend analysis and to better identify operating trends that may otherwise be masked or distorted by these types of items, and it provides a higher degree of transparency of certain items. Certain of these non-GAAP financial measures are used as metrics for our incentive compensation programs.

Our non-GAAP adjusted net earnings used for internal management purposes for the three and six month periods ended June 30, 2011 were \$232.5 million and \$463.4 million, respectively, compared to \$221.2 million and \$428.6 million in the same prior year periods, respectively. Our non-GAAP adjusted diluted earnings per share for the three and six month periods ended June 30, 2011 were \$1.21 and \$2.40, respectively, compared to \$1.09 and \$2.10 in the same prior year periods, respectively.

Our non-GAAP adjusted net earnings and adjusted diluted earnings per share increased in the 2011 periods compared to the 2010 periods due to increased sales, disciplined spending in SG&A, and lower product liability costs. These improvements were slightly offset by higher product costs, higher surgeon medical training and education expenses and additional intangible amortization.

The following are reconciliations from our GAAP net earnings and diluted earnings per share to our non-GAAP adjusted net earnings and non-GAAP adjusted diluted earnings per share.

<u>(In millions)</u>	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
Net Earnings of Zimmer Holdings, Inc. . . . .	\$203.8	\$165.5	\$412.7	\$370.9
Inventory step-up . . . . .	3.4	—	7.8	1.3
Certain claims . . . . .	50.0	75.0	50.0	75.0
Special items . . . . .	13.5	11.5	39.0	14.1
Taxes on inventory step-up, certain claims and special items and tax adjustments related to resolution of certain tax matters* . . . . .	<u>(38.2)</u>	<u>(30.8)</u>	<u>(46.1)</u>	<u>(32.7)</u>
Adjusted Net Earnings . . . . .	<u>\$232.5</u>	<u>\$221.2</u>	<u>\$463.4</u>	<u>\$428.6</u>

\* The tax effect is calculated based upon the statutory rates for the jurisdictions where the items were incurred.

	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
Diluted EPS . . . . .	\$ 1.06	\$ 0.82	\$ 2.14	\$ 1.82
Inventory step-up . . . . .	0.02	—	0.04	0.01
Certain claims . . . . .	0.26	0.37	0.26	0.37
Special items . . . . .	0.07	0.05	0.20	0.06
Taxes on inventory step-up, certain claims and special items and tax adjustments related to resolution of certain tax matters* . . . . .	<u>(0.20)</u>	<u>(0.15)</u>	<u>(0.24)</u>	<u>(0.16)</u>
Adjusted Diluted EPS . . . . .	<u>\$ 1.21</u>	<u>\$ 1.09</u>	<u>\$ 2.40</u>	<u>\$ 2.10</u>

\* The tax effect is calculated based upon the statutory rates for the jurisdictions where the items were incurred.

### ***Healthcare Reform in the U.S.***

We continue to assess the impact that federal healthcare reform will have on our business. Federal healthcare reform includes a 2.3 percent excise tax on a majority of our U.S. sales that is scheduled to be implemented in 2013.

### **Liquidity and Capital Resources**

Cash flows provided by operating activities were \$433.2 million for the six month period ended June 30, 2011, compared to \$532.2 million in the same prior year period. The principal source of cash from operating activities was net earnings. Non-cash items included in net earnings accounted for another \$214.2 million of operating cash. All other items of operating cash flows reflect a use of \$193.7 million of cash, compared to a use of \$36.4 million in the same 2010 period. The lower cash flows provided by operating activities in the 2011 period were primarily due to lower receivable collections, investments in inventory, increased pension funding, and increased product liability payments.

At June 30, 2011, we had 68 days of sales outstanding in trade accounts receivable, which represents an increase of 2 days compared to March 31, 2011 and an increase of 7 days compared to June 30, 2010, reflecting changes in certain accounts receivable factoring programs in our Europe operating segment. At June 30, 2011, we had 307 days of inventory on hand, which is a decrease of 5 days compared to March 31, 2011 and a decrease of 11 days from June 30, 2010. Despite an increase in inventory value to support new product launches, days of inventory on hand have decreased slightly due to higher cost of products sold that are part of the denominator in this calculation.

Cash flows used in investing activities were \$162.5 million for the six month period ended June 30, 2011, compared to \$91.9 million in the same prior year period. Additions to instruments increased slightly in the 2011 period compared to the 2010 period to support new product launches, such as our *Continuum* Acetabular System, and to support sales growth. Spending on other property, plant and equipment increased in the 2011 period compared to the 2010 period, reflecting cash outlays necessary to complete new product-related investments and replace older machinery and equipment. We invest our cash and cash equivalents in highly rated debt securities. The purchases and any sales or maturities of these investments are reflected as cash flows from investing activities. We increased our purchases of investments beginning in the second half of 2010 and into 2011, which explains the increased investment activity in the first six months of 2011 compared to the same 2010 period. Investments in other assets increased in the 2011 period compared to the 2010 period primarily for payments to acquire certain foreign-based distributors and payments for exclusive distribution rights for certain products.

Cash flows used in financing activities were \$324.3 million for the three month period ended June 30, 2011, compared to \$169.8 million in the same 2010 period. In the 2011 period, we repurchased 6.1 million common shares for a total of \$357.2 million, including commissions, under our share repurchase program authorized by our Board of Directors, compared to \$178.9 million in the same 2010 period. Proceeds from our stock compensation plans increased in the six month period ended June 30, 2011, compared to the same 2010 period, due to an increase in employee stock option exercises.

We have two outstanding tranches of unsecured senior notes (Senior Notes): \$500 million aggregate principal amount of 4.625 percent Senior Notes due November 30, 2019 and \$500 million aggregate principal amount of 5.75 percent Senior Notes due November 30, 2039. Interest on the Senior Notes is payable on May 30 and November 30 of each year until maturity.

We may redeem the Senior Notes at our election in whole or in part at any time prior to maturity at a redemption price equal to the greater of 1) 100 percent of the principal amount of the notes being redeemed; or 2) the sum of the present values of the remaining scheduled payments of principal and interest (not including any portion of such payments of interest accrued as of the date of redemption), discounted to the date of redemption on a semi-annual basis at the Treasury Rate (as defined in the debt agreement), plus 20 basis points, in the case of the 2019 notes, and 25 basis points, in the case of the 2039 notes. We will also pay the accrued and unpaid interest on the Senior Notes to the redemption date.



We have a five year \$1,350 million revolving, multi-currency, senior unsecured credit facility maturing November 30, 2012 (Senior Credit Facility). We had \$143.0 million in outstanding borrowings under the Senior Credit Facility as of June 30, 2011, and an availability of \$1,207.0 million.

We also have available uncommitted credit facilities totaling \$53.5 million.

We place our cash and cash equivalents in highly rated financial institutions and limit the amount of credit exposure to any one entity. We invest only in high-quality financial instruments in accordance with our internal investment policy.

As of June 30, 2011, we had short-term and long-term investments in debt securities with a fair value of \$425.7 million. These investments are in debt securities of many different issuers and therefore we have no significant concentration of risk with a single issuer. All of these debt securities are highly-rated and therefore we believe the risk of default by the issuer is low.

As of June 30, 2011, \$909.4 million of our cash and cash equivalents and short-term and long-term investments are held in jurisdictions outside of the U.S and expected to be indefinitely reinvested for continued use in foreign operations. Repatriation of these assets to the U.S. would have negative tax consequences. Approximately \$780 million of this amount is denominated in U.S. Dollars and therefore bears no foreign currency translation risk. The balance of these assets is denominated in currencies of the various countries where we operate.

We may use excess cash to repurchase additional common stock under our share repurchase program. As of June 30, 2011, approximately \$0.8 billion remained authorized under a \$1.5 billion repurchase program, which will expire on December 31, 2013.

Management believes that cash flows from operations and available borrowings under the Senior Credit Facility are sufficient to meet our working capital, capital expenditure and debt service needs. Should investment opportunities arise, we believe that our earnings, balance sheet and cash flows will allow us to obtain additional capital, if necessary.

### **Recent Accounting Pronouncements**

There are no recently issued accounting pronouncements that we have not yet adopted that are expected to have a material effect on our financial position, results of operations or cash flows.

### **Forward-Looking Statements**

This quarterly report contains certain statements that are forward-looking statements within the meaning of federal securities laws. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. When used in this report, the words “may,” “will,” “should,” “would,” “could,” “anticipate,” “expect,” “plan,” “seek,” “believe,” “predict,” “estimate,” “potential,” “project,” “target,” “forecast,” “intend,” “strategy,” “future,” “opportunity,” “assume,” “guide” and similar expressions are intended to identify forward-looking statements. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties that could cause actual results to differ materially from such forward-looking statements. These risks and uncertainties include, but are not limited to:

- our compliance through 2012 with the Corporate Integrity Agreement we entered into as part of the 2007 settlement with the United States government;
- the outcome of the investigation by the U.S. government into Foreign Corrupt Practices Act matters announced in 2007;
- competition;
- pricing pressures;
- changes in customer demand for our products and services caused by demographic changes or other factors;
- dependence on new product development, technological advances and innovation;

- product liability claims;
- retention of our independent agents and distributors;
- our ability to protect proprietary technology and other intellectual property and claims for infringement of the intellectual property rights of third parties;
- the possible disruptive effect of additional strategic acquisitions and our ability to successfully integrate acquired companies;
- our ability to form and implement strategic alliances;
- our dependence on a limited number of suppliers for key raw materials and outsourced activities;
- the impact of the federal healthcare reform legislation, including the impact of the new excise tax on medical devices;
- reductions in reimbursement levels by third-party payors and cost containment efforts of healthcare purchasing organizations;
- challenges relating to changes in and compliance with governmental laws and regulations affecting our U.S. and international businesses, including regulations of the U.S. Food and Drug Administration and foreign government regulators, such as more stringent requirements for regulatory clearance of our products;
- tax reform measures, tax authority examinations and associated tax risks and potential obligations;
- the success of our quality and operational improvement initiatives;
- the costs of defending or resolving putative class action litigation arising out of trading or ownership of our stock;
- changes in prices of raw materials and products and our ability to control costs and expenses;
- changes in general domestic and international economic conditions, including interest rate and currency exchange rate fluctuations;
- changes in general industry and market conditions, including domestic and international growth rates; and
- shifts in our product category sales mix or our regional sales mix away from products or geographic regions that generate higher operating margins.

Our Annual Report on Form 10-K for the year ended December 31, 2010 contains a detailed discussion of these and other important factors under the heading “Risk Factors” in Part I, Item 1A of that report. You should understand that it is not possible to predict or identify all factors that could cause actual results to differ materially from forward-looking statements. Consequently, you should not consider any list or discussion of such factors to be a complete set of all potential risks or uncertainties.

Readers of this report are cautioned not to place undue reliance on these forward-looking statements. While we believe the assumptions on which the forward-looking statements are based are reasonable, there can be no assurance that these forward-looking statements will prove to be accurate. This cautionary statement is applicable to all forward-looking statements contained in this report.

We expressly disclaim any obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. You are advised, however, to consult any further disclosures we make on related subjects in our Form 10-Q, 8-K and 10-K reports and our other filings with the Securities and Exchange Commission.

### **Item 3. *Quantitative and Qualitative Disclosures About Market Risk***

There have been no material changes from the information provided in our Annual Report on Form 10-K for the year ended December 31, 2010.



#### **Item 4. Controls and Procedures**

##### **Evaluation of Disclosure Controls and Procedures**

We maintain disclosure controls and procedures (as defined in Rules 13a-15(e) under the Securities Exchange Act of 1934 (the “Exchange Act”)) that are designed to provide reasonable assurance that information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosures. Because of inherent limitations, disclosure controls and procedures, no matter how well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of disclosure controls and procedures are met.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures are effective at a reasonable assurance level.

##### **Changes in Internal Control Over Financial Reporting**

There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) that occurred during the quarter ended June 30, 2011 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

### **Part II — Other Information**

#### **Item 1. Legal Proceedings**

Information pertaining to legal proceedings can be found in Note 15 to the interim condensed consolidated financial statements included in Part I of this report.

#### **Item 1A. Risk Factors**

There have been no material changes from the risk factors disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2010.

#### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The following table summarizes repurchases of common stock settled during the three month period ended June 30, 2011:

	<u>Total Number of Shares Purchased</u>	<u>Average Price Paid per Share</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs*</u>	<u>Approximate Dollar Value of Shares that May Yet Be Purchased Under Plans or Programs</u>
April 2011 .....	—	\$ —	63,267,163	\$969,670,852
May 2011 .....	1,040,000	69.16	64,307,163	897,748,742
June 2011 .....	<u>789,000</u>	<u>62.33</u>	<u>65,096,163</u>	<u>848,568,032</u>
Total .....	<u>1,829,000</u>	<u>\$66.21</u>	<u>65,096,163</u>	<u>\$848,568,032</u>

\* Includes repurchases made under expired programs as well as the current program authorizing \$1.5 billion of repurchases through December 31, 2013.

**Item 5. Other Information**

During the three month period ended June 30, 2011, the Audit Committee of our Board of Directors was not asked to, and did not, approve the engagement of PricewaterhouseCoopers LLP, our independent registered public accounting firm, to perform any non-audit services. This disclosure is made pursuant to Section 10A(i)(2) of the Exchange Act, as added by Section 202 of the Sarbanes-Oxley Act of 2002.

**Item 6. Exhibits**

The following exhibits are filed or furnished as part of this report:

- 31.1 Certification pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934 of the Chief Executive Officer, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934 of the Chief Financial Officer, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32 Certifications pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101.INS XBRL Instance Document\*
- 101.SCH XBRL Taxonomy Extension Schema Document\*
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document\*
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document\*
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document\*
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document\*

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\* Pursuant to Regulation S-T, this interactive data file is deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ZIMMER HOLDINGS, INC.  
(Registrant)

Date: August 8, 2011

By: /s/ James T. Crines  
James T. Crines  
*Executive Vice President, Finance and  
Chief Financial Officer*

Date: August 8, 2011

By: /s/ Derek M. Davis  
Derek M. Davis  
*Vice President, Finance and Corporate  
Controller and Chief Accounting Officer*