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

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**FORM 10-Q**

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

**FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2014**

Commission File Number 001-16407



**ZIMMER HOLDINGS, INC.**

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

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**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**

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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.

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 April 28, 2014, 167,819,367 shares of the registrant’s \$.01 par value common stock were outstanding.

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**ZIMMER HOLDINGS, INC.**

**INDEX TO FORM 10-Q**

**March 31, 2014**

	<u>Page</u>
<b>Part I — Financial Information</b>	
<b>Item 1.</b> Financial Statements	
Condensed Consolidated Statements of Earnings for the Three Months Ended March 31, 2014 and 2013 .....	3
Condensed Consolidated Statements of Comprehensive Income for the Three Months Ended March 31, 2014 and 2013 .....	4
Condensed Consolidated Balance Sheets as of March 31, 2014 and December 31, 2013 .....	5
Condensed Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2014 and 2013 .....	6
Notes to Interim Condensed Consolidated Financial Statements .....	7
<b>Item 2.</b> Management’s Discussion and Analysis of Financial Condition and Results of Operations ....	21
<b>Item 3.</b> Quantitative and Qualitative Disclosures About Market Risk .....	32
<b>Item 4.</b> Controls and Procedures .....	32
<b>Part II — Other Information</b>	
<b>Item 1.</b> Legal Proceedings .....	34
<b>Item 1A.</b> Risk Factors .....	34
<b>Item 2.</b> Unregistered Sales of Equity Securities and Use of Proceeds .....	36
<b>Item 3.</b> Defaults Upon Senior Securities .....	36
<b>Item 4.</b> Mine Safety Disclosures .....	36
<b>Item 5.</b> Other Information .....	36
<b>Item 6.</b> Exhibits .....	37
<b>Signatures</b> .....	38

**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 March 31,	
	2014	2013
<b>Net Sales</b> .....	\$1,161.5	\$1,138.9
Cost of products sold .....	305.4	292.9
<b>Gross Profit</b> .....	856.1	846.0
Research and development .....	47.5	53.5
Selling, general and administrative .....	464.3	460.8
Special items (Note 2) .....	45.9	33.5
Operating expenses .....	557.7	547.8
<b>Operating Profit</b> .....	298.4	298.2
Interest income .....	2.5	3.7
Interest expense .....	(15.0)	(18.2)
Earnings before income taxes .....	285.9	283.7
Provision for income taxes .....	64.8	65.7
Net earnings .....	221.1	218.0
Less: Net loss attributable to noncontrolling interest .....	(0.4)	(0.6)
<b>Net Earnings of Zimmer Holdings, Inc.</b> .....	\$ 221.5	\$ 218.6
<b>Earnings Per Common Share</b>		
Basic .....	\$ 1.31	\$ 1.30
Diluted .....	\$ 1.29	\$ 1.28
<b>Weighted Average Common Shares Outstanding</b>		
Basic .....	169.1	168.7
Diluted .....	171.8	170.7
<b>Cash Dividends Declared Per Common Share</b> .....	\$ 0.22	\$ 0.20

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

**ZIMMER HOLDINGS, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(in millions, unaudited)

	Three Months Ended March 31,	
	2014	2013
Net earnings .....	\$221.1	\$218.0
Other Comprehensive Income:		
Foreign currency cumulative translation adjustments .....	15.9	(65.0)
Unrealized cash flow hedge gains/(losses), net of tax .....	(3.1)	29.2
Reclassification adjustments on foreign currency hedges, net of tax .....	(2.0)	3.9
Unrealized gains/(losses) on securities, net of tax .....	0.1	(0.1)
Reclassification adjustments on securities, net of tax .....	(0.4)	—
Adjustments to prior service cost and unrecognized actuarial assumptions, net of tax .....	(1.9)	4.2
Total Other Comprehensive Gain/(Loss) .....	8.6	(27.8)
Comprehensive Income .....	229.7	190.2
Comprehensive loss attributable to the noncontrolling interest .....	(0.4)	(0.6)
Comprehensive Income attributable to Zimmer Holdings, Inc. ....	\$230.1	\$190.8

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>March 31,</u> <u>2014</u>	<u>December 31,</u> <u>2013</u>
<b>ASSETS</b>		
<b>Current Assets:</b>		
Cash and cash equivalents . . . . .	\$ 882.7	\$ 1,080.6
Short-term investments . . . . .	705.4	727.0
Accounts receivable, less allowance for doubtful accounts . . . . .	939.1	936.6
Inventories . . . . .	1,125.9	1,074.5
Prepaid expenses and other current assets . . . . .	96.3	107.1
Deferred income taxes . . . . .	297.3	271.9
<b>Total Current Assets</b> . . . . .	<u>4,046.7</u>	<u>4,197.7</u>
Property, plant and equipment, net . . . . .	1,235.6	1,224.7
Goodwill . . . . .	2,623.3	2,611.2
Intangible assets, net . . . . .	671.0	707.7
Other assets . . . . .	803.5	839.3
<b>Total Assets</b> . . . . .	<u><u>\$ 9,380.1</u></u>	<u><u>\$ 9,580.6</u></u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current Liabilities:</b>		
Accounts payable . . . . .	\$ 155.3	\$ 146.3
Income taxes . . . . .	155.1	221.2
Other current liabilities . . . . .	608.3	664.1
<b>Total Current Liabilities</b> . . . . .	<u>918.7</u>	<u>1,031.6</u>
Other long-term liabilities . . . . .	543.6	576.6
Long-term debt . . . . .	1,680.1	1,672.3
<b>Total Liabilities</b> . . . . .	<u>3,142.4</u>	<u>3,280.5</u>
<b>Commitments and Contingencies (Note 15)</b>		
<b>Stockholders' Equity:</b>		
Zimmer Holdings, Inc. Stockholders' Equity:		
Common stock, \$0.01 par value, one billion shares authorized, 266.4 million shares issued in 2014 (264.3 million in 2013) . . . . .	2.6	2.6
Paid-in capital . . . . .	4,146.0	4,000.6
Retained earnings . . . . .	7,897.3	7,712.7
Accumulated other comprehensive income . . . . .	375.7	367.1
Treasury stock, 98.7 million shares in 2014 (94.5 million shares in 2013) . . . . .	<u>(6,186.3)</u>	<u>(5,785.7)</u>
<b>Total Zimmer Holdings, Inc. stockholders' equity</b> . . . . .	<u>6,235.3</u>	<u>6,297.3</u>
Noncontrolling interest . . . . .	2.4	2.8
<b>Total Stockholders' Equity</b> . . . . .	<u>6,237.7</u>	<u>6,300.1</u>
<b>Total Liabilities and Stockholders' Equity</b> . . . . .	<u><u>\$ 9,380.1</u></u>	<u><u>\$ 9,580.6</u></u>

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

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

	For the Three Months Ended March 31,	
	2014	2013
<b>Cash flows provided by (used in) operating activities:</b>		
Net earnings	\$ 221.1	\$ 218.0
Adjustments to reconcile net earnings to cash provided by operating activities:		
Depreciation and amortization	101.0	85.1
Share-based compensation	11.2	14.0
Income tax benefit from stock option exercises	20.2	13.6
Excess income tax benefit from stock option exercises	(5.4)	(3.5)
Inventory step-up	2.5	0.8
Changes in operating assets and liabilities, net of effect of acquisitions:		
Income taxes	(75.6)	17.6
Receivables	5.3	(44.2)
Inventories	(56.6)	(59.7)
Accounts payable and accrued expenses	(56.0)	(31.3)
Other assets and liabilities	21.1	(29.9)
Net cash provided by operating activities	188.8	180.5
<b>Cash flows provided by (used in) investing activities:</b>		
Additions to instruments	(49.4)	(57.5)
Additions to other property, plant and equipment	(31.4)	(17.9)
Purchases of investments	(600.7)	(94.8)
Sales of investments	583.1	232.0
Investments in other assets	—	(8.8)
Net cash provided by (used in) investing activities	(98.4)	53.0
<b>Cash flows provided by (used in) financing activities:</b>		
Net payments under revolving credit facilities	0.2	(100.1)
Dividends paid to stockholders	(34.0)	(30.9)
Proceeds from employee stock compensation plans	138.2	67.0
Excess income tax benefit from stock option exercises	5.4	3.5
Repurchase of common stock	(400.5)	(392.0)
Net cash used in financing activities	(290.7)	(452.5)
Effect of exchange rates on cash and cash equivalents	2.4	(8.3)
Decrease in cash and cash equivalents	(197.9)	(227.3)
Cash and cash equivalents, beginning of year	1,080.6	884.3
Cash and cash equivalents, end of period	\$ 882.7	\$ 657.0

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 2013 Annual Report on Form 10-K filed by Zimmer Holdings, Inc. The condensed consolidated financial statements for the majority of our international subsidiaries are for periods that ended on March 25, 2014 and 2013. For these international subsidiaries, the three month results included in these condensed consolidated financial statements are for the period of December 26 through March 25 or the period of January 1 to March 25.

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, 2013 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 (GAAP). Results for interim periods should not be considered indicative of results for the full year. Certain amounts in the 2013 condensed consolidated financial statements have been reclassified to conform to the 2014 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 R&D agreements, certain contract terminations, consulting and professional fees and asset impairment or loss on disposal charges connected with global restructuring, quality and operational excellence initiatives, and other items as “Special items” in our condensed consolidated statement of earnings. “Special items” included (in millions):

	Three Months Ended March 31,	
	2014	2013
Impairment/loss on disposal of assets . . . . .	\$ 9.7	\$ 0.3
Consulting and professional fees . . . . .	15.0	26.9
Employee severance and retention . . . . .	0.9	(0.3)
Dedicated project personnel . . . . .	10.9	5.4
Certain R&D agreements . . . . .	4.5	—
Relocated facilities . . . . .	0.7	1.3
Certain litigation matters . . . . .	—	(3.8)
Contract terminations . . . . .	1.0	0.5
Contingent consideration adjustments . . . . .	0.5	0.3
Accelerated software amortization . . . . .	1.5	1.5
Other . . . . .	1.2	1.4
Special items . . . . .	\$45.9	\$33.5

In the three months ended March 31, 2014, we reduced the estimated useful lives of certain intangible assets to zero because we determined we would no longer utilize those assets. This was accounted for as a change in accounting estimate, which resulted in their remaining net book values of \$7.2 million being amortized immediately. We have included this amortization expense in the caption “Impairment/loss on disposal of assets.”

*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.

### 3. Inventories

	March 31, 2014	December 31, 2013
	(in millions)	
Finished goods .....	\$ 865.3	\$ 817.0
Work in progress .....	85.9	77.4
Raw materials .....	174.7	180.1
Inventories .....	<u>\$1,125.9</u>	<u>\$1,074.5</u>

### 4. Property, Plant and Equipment

	March 31, 2014	December 31, 2013
	(in millions)	
Land .....	\$ 21.7	\$ 21.7
Buildings and equipment .....	1,356.1	1,353.1
Capitalized software costs .....	278.2	272.6
Instruments .....	1,646.9	1,610.6
Construction in progress .....	75.1	58.2
	<u>3,378.0</u>	<u>3,316.2</u>
Accumulated depreciation .....	(2,142.4)	(2,091.5)
Property, plant and equipment, net .....	<u>\$ 1,235.6</u>	<u>\$ 1,224.7</u>

### 5. Investments

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

	Amortized Cost	Gross Unrealized		Fair value
		Gains	Losses	
<b>As of March 31, 2014</b>				
Corporate debt securities .....	\$288.7	\$0.3	\$(0.1)	\$288.9
U.S. government and agency debt securities .....	199.2	—	—	199.2
Foreign government debt securities .....	8.1	—	—	8.1
Commercial paper .....	267.3	—	(0.1)	267.2
Certificates of deposit .....	60.5	—	—	60.5
Total short and long-term investments .....	<u>\$823.8</u>	<u>\$0.3</u>	<u>\$(0.2)</u>	<u>\$823.9</u>
<b>As of December 31, 2013</b>				
Corporate debt securities .....	\$457.6	\$0.4	\$(0.1)	\$457.9
U.S. government and agency debt securities .....	211.1	0.1	—	211.2
Foreign government debt securities .....	3.1	—	—	3.1
Commercial paper .....	68.3	—	—	68.3
Certificates of deposit .....	67.2	—	—	67.2
Total short and long-term investments .....	<u>\$807.3</u>	<u>\$0.5</u>	<u>\$(0.1)</u>	<u>\$807.7</u>

The unrealized losses on our investments in corporate debt securities were caused by increases in interest yields in the global credit markets. We believe the unrealized losses associated with these securities as of March 31, 2014 are temporary because we do not intend to sell these investments, and we do not believe we will be required to sell them before recovery of their amortized cost basis.



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

	<u>March 31, 2014</u>	
	<u>Amortized Cost</u>	<u>Fair Value</u>
Due in one year or less .....	\$705.4	\$705.4
Due after one year through two years .....	118.4	118.5
Total .....	<u>\$823.8</u>	<u>\$823.9</u>

## 6. Other Current Liabilities

	<u>March 31, 2014</u>	<u>December 31, 2013</u>
	(in millions)	
Other current liabilities:		
Salaries, wages and benefits .....	\$ 77.6	\$122.8
Accrued liabilities .....	530.7	541.3
Total other current liabilities .....	<u>\$608.3</u>	<u>\$664.1</u>

## 7. Debt

Our debt consisted of the following (in millions):

	<u>March 31, 2014</u>	<u>December 31, 2013</u>
Long-term debt		
Senior Notes due 2014 .....	\$ 250.0	\$ 250.0
Senior Notes due 2019 .....	500.0	500.0
Senior Notes due 2021 .....	300.0	300.0
Senior Notes due 2039 .....	500.0	500.0
Term Loan .....	114.5	112.4
Other long-term debt .....	2.7	2.1
Debt discount .....	(1.5)	(1.5)
Adjustment related to interest rate swaps .....	14.4	9.3
Total long-term debt .....	<u>\$1,680.1</u>	<u>\$1,672.3</u>

The estimated fair value of our senior notes as of March 31, 2014, based on quoted prices for the specific securities from transactions in over-the-counter markets (Level 2), was \$1,700.7 million. The estimated fair value of the term loan as of March 31, 2014, based upon publicly available market yield curves and the terms of the debt (Level 2), was \$114.2 million.

Before our senior notes due November 30, 2014 become payable, we intend to borrow against our senior credit facility or issue new senior notes to pay the \$250 million owed. Since we have the ability and intent to refinance these senior notes on a long-term basis with new notes or through our senior credit facility, we have classified these senior notes as long-term debt as of March 31, 2014.

## 8. Accumulated Other Comprehensive Income

Other comprehensive income (OCI) refers to certain gains and losses that under GAAP are included in comprehensive income but are excluded from net earnings as these amounts are initially recorded as an adjustment to stockholders' equity. Amounts in OCI may be reclassified to net earnings upon the occurrence of certain events.

Our OCI is comprised of foreign currency translation adjustments, unrealized gains and losses on cash flow hedges, unrealized gains and losses on available-for-sale securities, and amortization of prior service costs and unrecognized gains and losses in actuarial assumptions on our defined benefit plans. Foreign currency translation adjustments are reclassified to net earnings upon sale or upon a complete or substantially complete liquidation of an investment in a foreign entity. Unrealized gains and losses on cash flow hedges are reclassified to net earnings when the hedged item affects net earnings. Unrealized gains and losses on available-for-sale securities are reclassified to net earnings if we sell the security before maturity or if the unrealized loss is considered to be other-than-temporary. Amounts related to defined benefit plans that are in OCI are reclassified over the service periods of employees in the plan. The reclassification amounts are allocated to all employees in the plans and therefore the reclassified amounts may become part of inventory to the extent they are considered direct labor costs. See Note 12 for more information on our defined benefit plans.

The following table shows the changes in the components of OCI, net of tax (in millions):

	<u>Foreign Currency Translation</u>	<u>Cash Flow Hedges</u>	<u>Unrealized Gains on Securities</u>	<u>Defined Benefit Plan Items</u>
Balance December 31, 2013 .....	\$401.1	\$33.1	\$ 0.5	\$(67.6)
OCI before reclassifications .....	15.9	(3.1)	0.1	—
Reclassifications .....	<u>—</u>	<u>(2.0)</u>	<u>(0.4)</u>	<u>(1.9)</u>
Balance March 31, 2014 .....	<u>\$417.0</u>	<u>\$28.0</u>	<u>\$ 0.2</u>	<u>\$(69.5)</u>

The following table shows the reclassification adjustments from OCI (in millions):

<u>Component of OCI</u>	<u>Amount of Gain / (Loss) Reclassified from OCI</u>		<u>Location on Statement of Earnings</u>
	<u>Three Months Ended March 31,</u>		
	<u>2014</u>	<u>2013</u>	
<i>Cash flow hedges</i>			
Foreign exchange forward contracts .....	\$ 5.0	\$(5.4)	Cost of products sold
Foreign exchange options .....	<u>(0.1)</u>	<u>(0.1)</u>	Cost of products sold
	4.9	(5.5)	Total before tax
	<u>2.9</u>	<u>(1.6)</u>	Provision for income taxes
	<u>\$ 2.0</u>	<u>\$(3.9)</u>	Net of tax
<i>Investments</i>			
Realized gains on securities .....	0.4	—	Interest income
	<u>—</u>	<u>—</u>	Provision for income taxes
	<u>\$ 0.4</u>	<u>\$ —</u>	Net of tax
<i>Defined benefit plans</i>			
Prior service cost .....	\$ 1.0	\$ 1.0	*
Unrecognized actuarial (loss) .....	<u>(2.9)</u>	<u>(4.7)</u>	*
	(1.9)	(3.7)	Total before tax
	<u>—</u>	<u>0.5</u>	Provision for income taxes
	<u>\$(1.9)</u>	<u>\$(4.2)</u>	Net of tax
Total reclassifications .....	<u>\$ 0.5</u>	<u>\$(8.1)</u>	Net of tax

\* These OCI components are included in the computation of net periodic pension expense (see Note 12).

The following table shows the tax effects on each component of OCI recognized in our condensed consolidated statements of comprehensive income (in millions):

	Three Months Ended March 31, 2014			Three Months Ended March 31, 2013		
	Before Tax	Tax	Net of Tax	Before Tax	Tax	Net of Tax
Foreign currency cumulative translation adjustments . . . . .	\$15.9	\$ —	\$15.9	\$(65.0)	\$ —	\$(65.0)
Unrealized cash flow hedge gains/(losses) . . . . .	(3.9)	(0.8)	(3.1)	44.8	15.6	29.2
Reclassification adjustments on foreign currency hedges . . . . .	(4.9)	(2.9)	(2.0)	5.5	1.6	3.9
Unrealized gains/(losses) on securities . .	0.1	—	0.1	(0.1)	—	(0.1)
Reclassification adjustments on securities . . . . .	(0.4)	—	(0.4)	—	—	—
Adjustments to prior service cost and unrecognized actuarial assumptions . .	<u>(1.9)</u>	<u>—</u>	<u>(1.9)</u>	<u>3.7</u>	<u>(0.5)</u>	<u>4.2</u>
Total Other Comprehensive Gain/(Loss) . . . . .	<u>\$ 4.9</u>	<u>\$(3.7)</u>	<u>\$ 8.6</u>	<u>\$(11.1)</u>	<u>\$16.7</u>	<u>\$(27.8)</u>

## 9. Fair Value Measurement of Assets and Liabilities

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

Description	As of March 31, 2014			
	Recorded Balance	Fair Value Measurements at Reporting Date Using:		
		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 . . . . .	\$288.9	\$—	\$288.9	\$—
U.S. government and agency debt securities . . . . .	199.2	—	199.2	—
Foreign government debt securities . . . . .	8.1	—	8.1	—
Commercial paper . . . . .	267.2	—	267.2	—
Certificates of deposit . . . . .	<u>60.5</u>	<u>—</u>	<u>60.5</u>	<u>—</u>
Total available-for-sale securities . . . . .	823.9	—	823.9	—
Derivatives, current and long-term				
Foreign currency forward contracts and options . . . . .	49.2	—	49.2	—
Interest rate swaps . . . . .	<u>17.1</u>	<u>—</u>	<u>17.1</u>	<u>—</u>
	<u>\$890.2</u>	<u>\$—</u>	<u>\$890.2</u>	<u>\$—</u>
<b>Liabilities</b>				
Derivatives, current and long-term				
Foreign currency forward contracts and options . . . . .	18.3	—	18.3	—
Interest rate swaps . . . . .	<u>2.7</u>	<u>—</u>	<u>2.7</u>	<u>—</u>
	<u>\$ 21.0</u>	<u>\$—</u>	<u>\$ 21.0</u>	<u>\$—</u>

<u>Description</u>	<b>As of December 31, 2013</b>			
	<b>Fair Value Measurements at Reporting Date Using:</b>			
	<b>Recorded Balance</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
<b>Assets</b>				
Available-for-sale securities				
Corporate debt securities . . . . .	\$457.9	\$—	\$457.9	\$—
U.S. government and agency debt securities . . . . .	211.2	—	211.2	—
Foreign government debt securities . . . . .	3.1	—	3.1	—
Commercial paper . . . . .	68.3	—	68.3	—
Certificates of deposit . . . . .	<u>67.2</u>	<u>—</u>	<u>67.2</u>	<u>—</u>
Total available-for-sale securities . . . . .	807.7	—	807.7	—
Derivatives, current and long-term				
Foreign currency forward contracts and options . . . . .	68.7	—	68.7	—
Interest rate swaps . . . . .	<u>16.3</u>	<u>—</u>	<u>16.3</u>	<u>—</u>
	<u>\$892.7</u>	<u>\$—</u>	<u>\$892.7</u>	<u>\$—</u>
<b>Liabilities</b>				
Derivatives, current and long-term				
Foreign currency forward contracts and options . . . . .	20.6	—	20.6	—
Interest rate swaps . . . . .	<u>7.0</u>	<u>—</u>	<u>7.0</u>	<u>—</u>
	<u>\$ 27.6</u>	<u>\$—</u>	<u>\$ 27.6</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 and we perform ongoing assessments of counterparty credit risk.

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 we 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 and we 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.

### 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 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.

We have multiple fixed-to-variable interest rate swap agreements that we have designated as fair value hedges of the fixed interest rate obligations on our senior notes due 2019 and 2021. The total notional amounts are \$250 million and \$300 million for the senior notes due 2019 and 2021, respectively. On the interest rate swap agreements for the senior notes due 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 the interest rate swap agreements for the senior notes due 2021, we receive a fixed interest rate of 3.375 percent and pay variable interest equal to the three-month LIBOR plus an average of 99 basis points.

### **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 foreign currency exchange forward contracts and options outstanding at March 31, 2014, we had 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 obligations to purchase Swiss Francs and sell U.S. Dollars. These derivatives mature at dates ranging from April 2014 through September 2016. As of March 31, 2014, the notional amounts of outstanding forward contracts and options entered into with third parties to purchase U.S. Dollars were \$1,564.9 million. As of March 31, 2014, the notional amounts of outstanding forward contracts and options entered into with third parties to purchase Swiss Francs were \$344.5 million.

#### ***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.

## Income Statement Presentation

### *Derivatives Designated as Fair Value Hedges*

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

<u>Derivative Instrument</u>	<u>Location on Statement of Earnings</u>	<u>Gain / (Loss) on Instrument</u>		<u>Gain / (Loss) on Hedged Item</u>	
		<u>Three Months Ended March 31,</u>		<u>Three Months Ended March 31,</u>	
		<u>2014</u>	<u>2013</u>	<u>2014</u>	<u>2013</u>
Interest rate swaps . . . . .	Interest expense	\$5.1	\$(3.3)	\$(5.1)	\$3.3

We had no ineffective fair value hedging instruments during the three month periods ended March 31, 2014 and 2013.

### *Derivatives Designated as Cash Flow Hedges*

Derivative instruments designated as cash flow hedges had the following effects, before taxes, on OCI and net earnings on our condensed consolidated statements of earnings, condensed consolidated statements of comprehensive income and condensed consolidated balance sheets (in millions):

<u>Derivative Instrument</u>	<u>Amount of Gain / (Loss) Recognized in OCI</u>		<u>Location on Statement of Earnings</u>	<u>Amount of Gain / (Loss) Reclassified from OCI</u>	
	<u>Three Months Ended March 31,</u>			<u>Three Months Ended March 31,</u>	
	<u>2014</u>	<u>2013</u>		<u>2014</u>	<u>2013</u>
Foreign exchange forward contracts . . .	\$(3.9)	\$45.3	Cost of products sold	\$ 5.0	\$(5.4)
Foreign exchange options . . . . .	—	(0.5)	Cost of products sold	(0.1)	(0.1)
	<u>\$(3.9)</u>	<u>\$44.8</u>		<u>\$ 4.9</u>	<u>\$(5.5)</u>

The net amount recognized in earnings during the three month periods ended March 31, 2014 and 2013 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 March 31, 2014, together with settled derivatives where the hedged item has not yet affected earnings, was a net unrealized gain of \$51.9 million, or \$28.0 million after taxes, which is deferred in OCI. Of the net unrealized gain, \$29.1 million, or \$14.8 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 statements of earnings (in millions):

<u>Derivative Instrument</u>	<u>Location on Statement of Earnings</u>	<u>Three Months Ended March 31,</u>	
		<u>2014</u>	<u>2013</u>
Foreign exchange forward contracts . . . . .	Cost of products sold	\$(2.4)	\$7.9

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 March 31, 2014 and December 31, 2013, all derivative instruments designated as fair value hedges and cash flow hedges were recorded at fair value on the balance sheet. On our condensed consolidated balance sheets, we recognize individual forward contracts and options with the same counterparty on a net asset/liability basis if we have a master netting agreement with the counterparty. Under these master netting agreements, we are able to settle derivative instrument assets and liabilities with the same counterparty in a single transaction, instead of settling each derivative instrument separately. We have master netting agreements with all of our counterparties. The fair value of derivative instruments on a gross basis is as follows (in millions):

	<u>March 31, 2014</u>		<u>December 31, 2013</u>	
	<u>Balance Sheet Location</u>	<u>Fair Value</u>	<u>Balance Sheet Location</u>	<u>Fair Value</u>
<b><i>Asset Derivatives</i></b>				
Foreign exchange forward contracts . . .	Other current assets	\$50.9	Other current assets	\$ 60.2
Foreign exchange forward contracts . . .	Other assets	18.8	Other assets	30.2
Interest rate swaps . . . . .	Other assets	17.1	Other assets	16.3
<b>Total asset derivatives . . . . .</b>		<u>\$86.8</u>		<u>\$106.7</u>
<b><i>Liability Derivatives</i></b>				
Foreign exchange forward contracts . . .	Other current liabilities	\$25.4	Other current liabilities	\$ 26.4
Foreign exchange forward contracts . . .	Other long-term liabilities	13.4	Other long-term liabilities	15.9
Interest rate swaps . . . . .	Other long-term liabilities	2.7	Other long-term liabilities	7.0
<b>Total liability derivatives . . . . .</b>		<u>\$41.5</u>		<u>\$ 49.3</u>

The table below presents the effects of our master netting agreements on our condensed consolidated balance sheets (in millions):

<u>Description</u>	<u>Location</u>	<u>As of March 31, 2014</u>			<u>As of December 31, 2013</u>		
		<u>Gross Amount</u>	<u>Offset</u>	<u>Net Amount in Balance Sheet</u>	<u>Gross Amount</u>	<u>Offset</u>	<u>Net Amount in Balance Sheet</u>
<b><i>Asset Derivatives</i></b>							
Cash flow hedges . .	Other current assets	\$50.9	\$13.6	\$37.3	\$60.2	\$13.5	\$46.7
Cash flow hedges . .	Other assets	18.8	6.9	11.9	30.2	8.2	22.0
<b><i>Liability Derivatives</i></b>							
Cash flow hedges . .	Other current liabilities	25.4	13.6	11.8	26.4	13.5	12.9
Cash flow hedges . .	Other long-term liabilities	13.4	6.9	6.5	15.9	8.2	7.7

## **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. We estimate that the amount of unrecognized tax benefits may change within the next twelve months between \$0 and \$60 million due to changes in audit status, expiration of statutes of limitations, settlements of tax assessments and other events which could impact our determination of unrecognized tax benefits.

During the second quarter of 2011, the Internal Revenue Service (IRS) concluded its examination of our U.S. federal returns for years 2005 through 2007 and during the fourth quarter of 2013, the IRS concluded its examination of our U.S. federal returns for years 2008 through 2009. For years 2006 through 2009, the IRS has proposed adjustments reallocating profits between certain of our U.S. and foreign subsidiaries. We have disputed these proposed adjustments and continue to pursue resolution with the IRS. Although the ultimate timing for resolution of the disputed tax issues is uncertain, we may resolve certain tax matters with the IRS within the next twelve months, and pay amounts for other unresolved tax matters in order to limit the potential impact of IRS



interest charges. Final resolution of these matters could have a material impact on our income tax expense, results of operations and cash flows for future periods.

In the three month period ended March 31, 2014, our effective tax rate was 22.7 percent. Our effective tax rate was lower than the U.S. statutory income tax rate of 35 percent primarily due to income earned in foreign locations with lower tax rates as well as an international reorganization resulting in the release of a valuation allowance on foreign net operating loss carryforwards.

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

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

	Three Months Ended March 31,	
	2014	2013
Service cost . . . . .	\$ 6.7	\$ 7.1
Interest cost . . . . .	6.4	4.7
Expected return on plan assets . . . . .	(10.4)	(8.9)
Amortization of prior service cost . . . . .	(1.0)	(1.0)
Amortization of unrecognized actuarial loss . . . . .	2.9	4.7
Net periodic pension expense . . . . .	<u>\$ 4.6</u>	<u>\$ 6.6</u>

We contributed \$2.0 million during the three month period ended March 31, 2014 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 2014. We contributed \$3.6 million to our foreign-based defined benefit plans in the three month period ended March 31, 2014 and expect to contribute \$11.0 million to these foreign-based plans during the remainder of 2014.

## 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 March 31,	
	2014	2013
Weighted average shares outstanding for basic net earnings per share . . . . .	169.1	168.7
Effect of dilutive stock options and other equity awards . . . . .	<u>2.7</u>	<u>2.0</u>
Weighted average shares outstanding for diluted net earnings per share . . . . .	<u>171.8</u>	<u>170.7</u>

During the three month period ended March 31, 2014, all outstanding options to purchase shares of common stock were included in the computation of diluted earnings per share because the exercise prices of all options were less than the average market price of our common stock. During the three month period ended March 31, 2013, an average of 6.3 million options had exercise prices that were greater than the average market price of our common stock and were not included in the computation.

In the three month period ended March 31, 2014, we repurchased 4.2 million shares of our common stock at an average price of \$94.57 per share for a total cash outlay of \$400.5 million, including commissions.



#### 14. Segment Information

We design, develop, manufacture and market orthopaedic reconstructive implants, biologics, 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. 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 and certain other inventory and manufacturing related charges, “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., Puerto Rico and Ireland-based manufacturing operations and logistics and intangible asset 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 March 31,		Three Months Ended March 31,	
	2014	2013	2014	2013
Americas .....	\$ 638.7	\$ 634.7	\$ 309.9	\$ 320.6
Europe .....	326.9	307.5	101.7	88.3
Asia Pacific .....	195.9	196.7	94.5	80.4
Total .....	<u>\$1,161.5</u>	<u>\$1,138.9</u>		
Share-based compensation .....			(11.2)	(14.0)
Inventory step-up .....			(2.5)	(2.2)
Special items .....			(45.9)	(33.5)
Global operations and corporate functions .....			(148.1)	(141.4)
Operating profit .....			<u>\$ 298.4</u>	<u>\$ 298.2</u>

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

	Three Months Ended March 31,	
	2014	2013
Reconstructive		
Knees .....	\$ 487.9	\$ 471.0
Hips .....	331.7	330.8
Extremities .....	52.1	47.8
	871.7	849.6
Dental .....	61.0	59.7
Trauma .....	79.7	82.0
Spine .....	48.3	47.7
Surgical and other .....	100.8	99.9
Total .....	<u>\$1,161.5</u>	<u>\$1,138.9</u>

#### 15. Commitments and Contingencies

On a quarterly and annual basis, we review relevant information with respect to loss contingencies and update our accruals, disclosures and estimates of reasonably possible losses or ranges of loss based on such

reviews. We establish liabilities for loss contingencies when it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated. For matters where a loss is believed to be reasonably possible, but not probable, no accrual has been made.

## Litigation

*Durom*<sup>®</sup> Cup-related claims: On July 22, 2008, we temporarily suspended marketing and distribution of the *Durom* Acetabular Component (*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.

Since 2008, we have recognized expense of \$450.2 million for *Durom* Cup-related claims. With respect to the period covered by this report, our estimate of our total liability for these claims as of March 31, 2014 remains consistent with our prior estimate, and, accordingly, we did not record any additional expense during the three month period ended March 31, 2014. With respect to the same prior year period, we also did not record any additional expense for *Durom* Cup-related claims.

We maintain insurance for product liability claims, subject to self-insurance retention requirements. In 2008, we notified our insurance carriers of potential claims related to the *Durom* Cup. Based upon our most recent estimates for liabilities associated with the *Durom* Cup, we believe we may exhaust our self-insured retention under our insurance program. In this event, we would have a claim for insurance proceeds for ultimate losses which exceed the self-insured retention amount, subject to a 20 percent co-payment requirement and a cap. We believe our contracts with the insurance carriers are enforceable for these claims and, therefore, we believe it is probable that we would recover some amount from our insurance carriers if our ultimate losses exceed our self-insured retention. We have recognized a \$218.0 million receivable in "Other assets" on our condensed consolidated balance sheet as of March 31, 2014 for estimated insurance recoveries, which reduced "Certain claims" expense. As is customary in this process, our insurance carriers have reserved all rights under their respective policies and could still ultimately deny coverage for some or all of our insurance claims.

Our estimate as of March 31, 2014 of the remaining liability for all *Durom* Cup-related claims is \$372.3 million, of which \$50.0 million is classified as short-term in "Other current liabilities" and \$322.3 million is classified as long-term in "Other long-term liabilities" on our condensed consolidated balance sheet. We expect to pay the majority of the *Durom* Cup-related claims within the next five years.

Our understanding of clinical outcomes with the *Durom* Cup and other large diameter hip cups continues to evolve. 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. Among other factors, since our understanding of the clinical outcomes is still evolving, 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.

Margo and Daniel Polett v. Zimmer, Inc. et al.: 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. Oral argument before the appellate court in Philadelphia, Pennsylvania was held as scheduled on March 13, 2012. On March 1, 2013, the Superior Court of Pennsylvania vacated the \$27.6 million judgment and remanded the case for a new trial. On March 15, 2013, plaintiffs filed a

motion for re-argument en banc, and on March 28, 2013, we filed our response in opposition. On May 9, 2013, the Superior Court of Pennsylvania granted plaintiffs' motion for re-argument en banc. Oral argument (re-argument en banc) before the Superior Court of Pennsylvania was held on October 16, 2013. On December 20, 2013, the Court issued its opinion again vacating the trial court judgment and remanding the case for a new trial. On January 21, 2014, plaintiffs filed a petition for allowance of appeal in the Supreme Court of Pennsylvania, and on February 4, 2014, we filed our response in opposition. Although we are defending this lawsuit vigorously, its ultimate resolution is uncertain.

*NexGen*<sup>®</sup> Knee System claims: Following a wide-spread advertising campaign conducted by certain law firms beginning in 2010, a number of product liability lawsuits have been filed against us in various jurisdictions. The plaintiffs seek damages for personal injury, alleging that certain products within the *NexGen* Knee System suffer from defects that cause them to loosen prematurely. The majority of the cases are currently pending in a federal Multidistrict Litigation in the Northern District of Illinois. Other cases are pending in other state and federal courts, and additional lawsuits may be filed. As of March 31, 2014, discovery in these lawsuits was underway and no trial dates had been set. We have not accrued an estimated loss relating to these lawsuits because we believe the plaintiffs' allegations are not consistent with the record of clinical success for these products. As a result, we do not believe that it is probable that we have incurred a liability, and we cannot reasonably estimate any loss that might eventually be incurred. Although we are vigorously defending these lawsuits, their ultimate resolution is uncertain.

### **Intellectual Property-Related Claims**

Patent infringement lawsuit: On December 10, 2010, Stryker Corporation and related entities (Stryker) filed suit against us in the U.S. District Court for the Western District of Michigan, alleging that certain of our *Pulsavac*<sup>®</sup> Plus Wound Debridement Products infringe three U.S. patents assigned to Stryker. The case was tried beginning on January 15, 2013, and on February 5, 2013, the jury found that we infringed certain claims of the subject patents. The jury awarded \$70.0 million in monetary damages for lost profits. The jury also found that we willfully infringed the subject patents. We filed multiple post-trial motions, including a motion seeking a new trial. On August 7, 2013, the trial court issued a ruling denying all of our motions and awarded treble damages and attorneys' fees to Stryker. We filed a notice of appeal to the Court of Appeals for the Federal Circuit to seek reversal of both the jury's verdict and the trial court's rulings on our post-trial motions. That appeal is pending. We have not accrued an estimated loss related to this matter in our condensed consolidated statement of earnings for the quarter ended March 31, 2014 or any prior period because we do not believe that it is probable that we have incurred a liability. Although we believe we have strong grounds to reverse the trial court's judgment, the ultimate resolution of this matter is uncertain. In the future we could be required to record a charge of up to \$210.0 million plus interest and attorneys' fees that could have a material adverse effect on our results of operations.

### **Regulatory Matters**

In September 2012, we received a warning letter from the U.S. Food and Drug Administration (FDA) citing concerns relating to certain manufacturing and validation processes pertaining to *Trilogy*<sup>®</sup> Acetabular System products manufactured at our Ponce, Puerto Rico manufacturing facility. We have provided detailed responses to the FDA as to our corrective actions and will continue to work expeditiously to address the issues identified by the FDA during inspections in Ponce. As of March 31, 2014, the warning letter remains pending. Until the violations are corrected, we may be subject to additional regulatory action by the FDA, including seizure, injunction and/or civil monetary penalties. Additionally, requests for Certificates to Foreign Governments related to products manufactured at the Ponce facility may not be granted and premarket approval applications for Class III devices to which the quality system regulation deviations are reasonably related will not be approved until the violations have been corrected. In addition to responding to the warning letter described above, we are in the process of addressing various FDA Form 483 inspectional observations at certain of our manufacturing facilities. The ultimate outcome of these matters is presently uncertain.

## **16. Subsequent Event**

On April 24, 2014, we entered into a definitive agreement to merge with LVB Acquisition, Inc. (LVB), the parent company of Biomet, Inc. (Biomet), in a cash and stock transaction valued at approximately \$13.35 billion. We will pay \$10.35 billion in cash and issue 32.7 million shares of our common stock which had a value of approximately \$3.0 billion, based on a stock price of \$91.73 per share using the five day volume weighted average price immediately preceding the signing of the agreement. In connection with the merger, we will pay off all of LVB's outstanding funded debt, and the aggregate cash merger consideration will be reduced by such amount. The transaction, which is subject to customary closing conditions and regulatory approvals, is expected to close in the first quarter of 2015. The transaction will position the combined company as a leader in the \$45 billion musculoskeletal industry.

Biomet's product portfolio includes knee and hip reconstructive products; sports medicine, extremities and trauma products; spine, bone healing and microfixation products; dental reconstructive products; and cement, biologics and other products. The combination will enhance enterprise diversification with broader franchises in the Knee, Hip, Surgical, Spine and Dental categories, as well as in the faster-growing Sports Medicine, Extremities and Trauma categories.

We expect to fund the cash portion of the purchase price with existing cash on hand, as well as proceeds obtained from a newly committed \$3.0 billion senior unsecured term loan and senior notes we intend to issue. In connection with our execution of the definitive agreement, in April 2014 we entered into a \$7.66 billion 364-day bridge facility, which we intend to reduce when the new senior notes are issued.

## **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 2013 condensed consolidated financial statements have been reclassified to conform to the 2014 presentation.

### **Executive Level Overview**

#### **Results for the Three Month Period ended March 31, 2014**

Our sales results for the three month period ended March 31, 2014 increased due to increased volume in the joint replacement market and product mix growth from premium priced new products, such as *Persona*<sup>®</sup> The Personalized Knee System. This was partially offset by continued pricing pressure, mostly in our Americas and Europe operating segments, as well as negative effects from changes in foreign currency exchange rates.

The increase in sales resulted in increased gross profit. Meanwhile, operating expenses were higher, primarily from spending on our quality and operational excellence initiatives. Since the increase in gross profit was tempered by increases in operating expenses, operating profit for the three month period ended March 31, 2014 was similar to the same prior year period. Interest expense, net, decreased due to fixed-to-variable interest rate swaps we entered into in the second half of 2013. Additionally, our effective tax rate (ETR) benefited from the release of a valuation allowance on foreign net operating loss carryforwards. As a result, net earnings increased slightly from the prior year.

#### **2014 Outlook**

The 2014 outlook discussed in this section does not include anticipated expenses associated with the pending merger with Biomet. We expect to incur significant expenses during the remainder of 2014 as we develop acquisition and integration plans in anticipation of the expected closing in the first quarter of 2015. We plan to report expenses related to acquisition and integration as part of "Special items." Additionally, we will incur additional interest expense (including debt issuance costs) related to new borrowings to fund the cash portion of the pending transaction. Our anticipated new borrowings are further discussed in the "Liquidity and Capital Resources" section of this discussion and analysis. At this time, it is difficult for us to estimate the amount of these expenses with any certainty, but we expect they will be significant relative to our operating results and cash flows in 2014.

We estimate our net sales will grow between 2.5 and 4.5 percent in 2014. This assumes the market for knee and hip procedures will remain stable and grow in the low to mid-single digits. We expect pricing to have a negative effect on sales growth of between 2 and 3 percent, and foreign currency exchange rates to have a negative effect on sales growth of between 0 and 1 percent based upon March 31, 2014 rates.

Assuming currency rates remain at March 31, 2014 levels, we expect our gross margin to be between 73 and 74 percent of sales in 2014, compared to 72.2 percent for the full year in 2013. In the 2013 period, we recognized significant excess and obsolescence charges related to products we intend to discontinue and similar significant charges are not expected in 2014. The 2014 range assumes that foreign currency hedge gains will be higher than in 2013. The range also takes into consideration the full year impact of the 2.3 percent medical device excise tax on a majority of our U.S. sales. Based upon the levels of inventory we were carrying before the medical device excise tax was effective on January 1, 2013, we did not recognize any significant expenses from the excise tax until the fourth quarter of 2013. We estimate the cost in 2014 will be approximately \$10 million per quarter. Since we recognize the medical device excise tax as a part of the cost of inventory, the amount expensed in any particular quarter will vary according to U.S. sales levels in that quarter.

We expect to continue making investments in research and development (R&D) of between 4 and 4.5 percent of sales in 2014. Selling, general and administrative expenses (SG&A) as a percentage of sales is expected to be between 38.5 and 39 percent in 2014 as we realize efficiencies from our quality and operational excellence initiatives and further leverage revenue growth.

We expect to incur approximately \$250 million of expenses in 2014 related to our quality and operational excellence initiatives and integration costs from recent acquisitions. The quality and operational excellence programs are intended to improve our future operating results and include centralizing or outsourcing certain functions and improving quality, distribution, sourcing, manufacturing and information technology systems. We expect to recognize the majority of these expenses in “Special items” on our statement of earnings, but some will be related to inventory and be reflected in costs of products sold.

Assuming variable interest rates remain at March 31, 2014 levels, we expect interest income and expense, net, to be similar to 2013, absent additional interest expense related to the pending transaction with Biomet.

We expect our ETR to increase in 2014 relative to 2013, as we do not anticipate certain significant costs, such as excess and obsolete inventory charges and “Certain claims” that were incurred in jurisdictions with higher tax rates in 2013, to recur, thus increasing the profit in those higher tax jurisdictions.

Based upon the above, we expect reported net earnings and diluted earnings per share to increase in a range of approximately 13 to 17 percent in 2014 as compared to 2013, stemming from anticipated higher sales and an improved gross margin.

### *Net Sales by Operating Segment*

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

	Three Months Ended March 31,		% Inc	Volume/ Mix	Price	Foreign Exchange
	2014	2013				
Americas .....	\$ 638.7	\$ 634.7	1%	4%	(3)%	—%
Europe .....	326.9	307.5	6	6	(2)	2
Asia Pacific .....	195.9	196.7	—	8	—	(8)
Total .....	<u>\$1,161.5</u>	<u>\$1,138.9</u>	2	5	(2)	(1)

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

### *Net Sales by Product Category*

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

	Three Months Ended March 31,		% Inc (Dec)	Volume/ Mix	Price	Foreign Exchange
	2014	2013				
<u>Reconstructive</u>						
Knees .....	\$ 487.9	\$ 471.0	4%	8%	(3)%	(1)%
Hips .....	331.7	330.8	—	4	(2)	(2)
Extremities .....	52.1	47.8	9	12	(3)	—
	871.7	849.6	3	7	(3)	(1)
Dental .....	61.0	59.7	2	2	—	—
Trauma .....	79.7	82.0	(3)	—	(1)	(2)
Spine .....	48.3	47.7	1	3	(2)	—
Surgical and other .....	100.8	99.9	1	4	(1)	(2)
Total .....	<u>\$1,161.5</u>	<u>\$1,138.9</u>	2	5	(2)	(1)

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

	<b>Three Months Ended March 31,</b>		
	<b>2014</b>	<b>2013</b>	<b>% Inc (Dec)</b>
<b>Reconstructive</b>			
<b>Knees</b>			
<i>Americas</i> .....	\$ 283.5	\$ 275.5	3%
<i>Europe</i> .....	131.1	122.5	7
<i>Asia Pacific</i> .....	73.3	73.0	—
<b>Hips</b>			
<i>Americas</i> .....	150.4	151.9	(1)
<i>Europe</i> .....	115.5	111.8	3
<i>Asia Pacific</i> .....	65.8	67.1	(2)
<b>Extremities</b>			
<i>Americas</i> .....	38.9	37.3	4
<i>Europe</i> .....	9.9	7.8	28
<i>Asia Pacific</i> .....	3.3	2.7	24
	<u>871.7</u>	<u>849.6</u>	3
<b>Dental</b>			
<i>Americas</i> .....	35.0	35.5	(1)
<i>Europe</i> .....	20.2	19.6	3
<i>Asia Pacific</i> .....	5.8	4.6	24
<b>Trauma</b>			
<i>Americas</i> .....	37.6	41.2	(9)
<i>Europe</i> .....	20.6	18.8	10
<i>Asia Pacific</i> .....	21.5	22.0	(2)
<b>Spine</b>			
<i>Americas</i> .....	30.1	30.7	(2)
<i>Europe</i> .....	12.5	12.2	2
<i>Asia Pacific</i> .....	5.7	4.8	18
<b>Surgical and other</b>			
<i>Americas</i> .....	63.2	62.6	1
<i>Europe</i> .....	17.1	14.8	15
<i>Asia Pacific</i> .....	20.5	22.5	(9)
<b>Total</b> .....	<u>\$1,161.5</u>	<u>\$1,138.9</u>	2

#### Demand (Volume and Mix) Trends

Increased volume and changes in the mix of product sales contributed 5 percentage points of year-over-year sales growth during the three month period ended March 31, 2014. The 5 percentage points of growth were lower than the year-over-year sales growth from volume/mix in the three month period ended December 31, 2013. We believe this reflects some seasonality, especially in the Americas.

We believe long-term indicators point toward sustained growth driven by an aging global population, growth in emerging markets, obesity, proven clinical benefits, new material technologies, advances in surgical techniques and more active lifestyles, among other factors. In addition, demand for clinically proven premium products and patient specific devices are expected to continue to positively affect sales growth in markets that recognize the value of these advanced technologies.

#### Pricing Trends

Global selling prices had a negative effect of 2 percentage points on year-over-year sales during the three month period ended March 31, 2014. Our Americas and Europe reporting segments and certain countries in our



Asia Pacific reporting segment continued to experience pricing pressure from governmental healthcare cost containment efforts and from local hospitals and health systems. For the entire year, we expect lower prices will have a negative effect on sales growth of between 2 and 3 percent.

#### Foreign Currency Exchange Rates

For the three month period ended March 31, 2014, foreign currency exchange rates resulted in a 1 percent decrease in sales, primarily from the strengthening of the U.S. Dollar versus the Japanese Yen in the period. If foreign currency exchange rates remain consistent with March 31, 2014 rates, we estimate that a stronger dollar versus foreign currency exchange rates will have a negative effect on sales growth in 2014 of between 0 and 1 percent. We address currency risk through regular operating and financing activities and through the use of forward contracts and foreign currency options solely to manage foreign currency volatility and risk. Changes to foreign currency exchange rates affect sales growth, but due to offsetting gains/losses on hedge contracts and options, which are recorded in cost of products sold, the effect on net earnings in the near term is expected to be minimal.

#### Sales by Product Category

##### *Knees*

Knee sales increased 4 percent in the three month period ended March 31, 2014 when compared to the same prior year period. Our Knee product category has benefited from new product introductions, such as *Persona* The Personalized Knee System and early intervention products.

In 2014, we have continued a broader launch of our new knee system, *Persona* The Personalized Knee System. We intend to continue to deploy implant and instrument sets to all geographic regions during the remainder of 2014 and beyond. In the meantime, our *NexGen*<sup>®</sup> Complete Knee Solution product line is still our leading knee system in terms of sales. Products driving growth in this category in addition to *Persona* The Personalized Knee System included the *Zimmer*<sup>®</sup> Unicompartmental High Flex Knee and our early intervention products.

In Europe, changes in foreign currency exchange rates positively affected knee sales in the three month period ended March 31, 2014 by 2 percent. In Asia Pacific, changes in foreign currency exchange rates negatively affected knee sales in the three month period ended March 31, 2014 by 10 percent.

##### *Hips*

Hip sales were flat in the three month period ended March 31, 2014 when compared to the same prior year period. Positive volume and mix trends continued to be offset by pricing pressure and changes in foreign currency exchange rates.

Leading hip stem sales were the *Zimmer*<sup>®</sup> M/L Taper Hip Prosthesis, the *Zimmer*<sup>®</sup> M/L Taper Hip Prosthesis with *Kinectiv*<sup>®</sup> Technology, the *CLS*<sup>®</sup> *Spotorno*<sup>®</sup> Stem from the *CLS* Hip System, the *Alloclassic*<sup>®</sup> *Zweymüller*<sup>®</sup> Hip Stem and the *Fitmore*<sup>®</sup> Hip Stem. Products experiencing growth in this category included the *Avenir*<sup>®</sup> Müller Stem, the *Wagner SL Revision*<sup>®</sup> Hip Stem, the *Continuum*<sup>®</sup> Acetabular System, the *Trilogy*<sup>®</sup> IT Acetabular System, the *Allofit*<sup>®</sup> IT *Alloclassic*<sup>®</sup> Acetabular System, *Vivacit-E*<sup>®</sup> Highly Crosslinked Polyethylene Liners and *BIOLOX*<sup>®1</sup> *delta* Heads.

In Europe, changes in foreign currency exchange rates positively affected hip sales in the three month period ended March 31, 2014 by 2 percent. In Asia Pacific, changes in foreign currency exchange rates negatively affected hip sales in the three month period ended March 31, 2014 by 9 percent.

##### *Extremities*

Extremities sales increased by 9 percent in the three month period ended March 31, 2014 when compared to the same prior year period. The sales increase reflects growth from our shoulder systems, such as the *Zimmer*<sup>®</sup> *Trabecular Metal*<sup>™</sup> Reverse Shoulder System and the *Sidus*<sup>®</sup> Stem-Free Shoulder, and a broader product

<sup>1</sup> Registered trademark of CeramTec GmbH



portfolio to compete in the foot and ankle and hand and wrist areas of the Extremities category. The broader portfolio includes the *Zimmer® Trabecular Metal* Total Ankle and products from the acquisition of NORMED Medizin-Technik GmbH in June 2013.

#### *Dental*

Dental sales increased by 2 percent in the three month period ended March 31, 2014 when compared to the same prior year period. This was the result of improved sales of dental reconstructive implants partially offset by decreases in digital solutions, restorative products and regenerative products. Sales were led by the *Tapered Screw-Vent®* Implant System.

#### *Trauma*

Trauma sales decreased 3 percent in the three month period ended March 31, 2014 when compared to the same prior year period. In the prior year period, we benefited from certain competitive product issues in this product category, especially in the Americas. In the current year, with the competitive product back on the market, we were not able to achieve the same level of sales as in the prior year. This caused our intramedullary nail product portfolio sales to decline in the current year, which was partially offset by growth in our plates and screws product portfolio. The *Zimmer Natural Nail®* System and *Zimmer®* Periarticular Locking Plates System led Trauma sales.

#### *Spine*

Spine sales increased by 1 percent in the three month period ended March 31, 2014 when compared to the same prior year period. We continue to focus on and have had slightly increased sales in our core fusion portfolio and market adjacencies, including minimally invasive surgeries. Solid sales of the *PathFinder NXT®* Minimally Invasive Pedicle Screw System and *Trabecular Metal* Technology products partly offset a decline in sales of the *Dynesys®* Dynamic Stabilization System, the *Trinica®* Select Anterior Cervical Plate System and other spine products.

#### *Surgical and other*

Surgical and other sales increased 1 percent in the three month period ended March 31, 2014 when compared to the same prior year period. The primary driver of sales growth in this product category was the *Transposal®* Fluid Waste Management System. With this system we sell capital equipment that is used with a one-time disposable manifold. In the prior year, this system benefitted from a competitive product being off the market. While that competitive product is back on the market, sales growth was still achieved as our customers continued to purchase the disposable manifolds to be used with the capital equipment. Other products leading sales in this category were *PALACOS®<sup>2</sup>* Bone Cement, tourniquets and wound debridement devices.

#### *Expenses as a Percentage of Net Sales*

	<b>Three Months Ended</b>		<b>Inc (Dec)</b>
	<b>March 31,</b>		
	<b>2014</b>	<b>2013</b>	
Cost of products sold . . . . .	26.3%	25.7%	0.6
Research and development . . . . .	4.1	4.7	(0.6)
Selling, general and administrative . . . . .	40.0	40.5	(0.5)
Special items . . . . .	4.0	2.9	1.1
Operating profit . . . . .	25.7	26.2	(0.5)

<sup>2</sup> Registered trademark of Heraeus Kulzer GmbH

### ***Cost of Products Sold***

The increase in cost of products sold as a percentage of net sales for the three month period ended March 31, 2014 compared to the same prior year period was primarily due to the medical device excise tax, lower average selling prices, and certain inventory and manufacturing related charges associated with our quality enhancement and remediation efforts. These negative effects were partially offset by hedge gains recorded in the 2014 period from our foreign currency hedging program versus hedge losses recorded in the 2013 period, and lower excess and obsolete inventory charges in the 2014 period. The hedge gains were primarily the result of the U.S. Dollar strengthening against the Japanese Yen. Under the 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 items affects earnings.

### ***Operating Expenses***

R&D expenses and R&D as a percentage of sales both declined in the three month period ended March 31, 2014 when compared to the same prior year period. The lower expense reflects a dedication of resources to our quality and operational excellence initiatives. We expect R&D spending in 2014 to be between 4 and 4.5 percent of sales for the full year.

SG&A expenses increased, but SG&A as a percentage of sales decreased, in the three month period ended March 31, 2014 when compared to the same prior year period. The dollar increase was primarily due to increased intangible amortization from acquisitions and higher employee-related expenses due to an increase in the number of employees and annual salary increases. However, these expense increases were partially offset by the effects of our operational excellence initiatives, which resulted in decreases in certain areas such as selling expenses. As a percentage of sales, SG&A expenses decreased in the 2014 period as our operational excellence initiatives produced lower variable and fixed costs in SG&A as net sales increased.

“Special items” for the three month period ended March 31, 2014 increased compared to the same prior year period. The increase was driven by the accelerated amortization on certain intangible assets, increased dedicated project personnel expenses related to our quality and operational excellence initiatives and certain R&D agreements we entered into with upfront payments to acquire intellectual property. We continue to implement our quality and operational excellence initiatives, which are intended to improve our future operating results by centralizing or outsourcing certain functions and improving quality, distribution, sourcing, manufacturing and our information technology systems. “Special items” expenses include consulting and professional fees, dedicated personnel costs, severance benefits as well as other costs for those programs. In addition to expenses for our quality and operational excellence programs, we recognize expenses related to integration of acquired businesses, impairment of assets, certain R&D agreements and other items as “Special items.” See Note 2 to the interim condensed consolidated financial statements included in Part I, Item 1 of this report for more information regarding “Special items” charges.

### ***Interest Income, Interest Expense, Income Taxes, Net Earnings and Segment Operating Profit***

Interest income and expense, net, decreased in the three month period ended March 31, 2014 when compared to the same prior year period. In the second half of 2013, we entered into additional fixed-to-variable rate interest swaps designated as fair value hedges. In the 2014 period, the variable rates we paid on the swaps were lower than the fixed rate on the hedged debt and therefore interest expense decreased.

The ETR on earnings before income taxes for the three month period ended March 31, 2014 decreased to 22.7 percent compared to 23.1 percent in the same prior year period. The decrease was primarily due to an international reorganization resulting in the release of a valuation allowance on foreign net operating loss carryforwards. We anticipate that the outcome of various federal, state and foreign audits, as well as expiration of certain statutes of limitations, could potentially impact our ETR in future quarters. Currently, we cannot reasonably estimate the impact of these items on our financial results.

Net earnings of Zimmer Holdings, Inc. of \$221.5 million for the three month period ended March 31, 2014 increased 1 percent compared to the same prior year period as a result of the changes in revenues and expenses discussed above. In the three month period ended March 31, 2014, basic and diluted earnings per share both

increased 1 percent as well. While we continued to repurchase shares in the first quarter, our overall basic and diluted shares outstanding increased compared to the same prior year period as an increase in our stock price resulted in significant stock option exercises by our employees and more dilutive shares outstanding as calculated pursuant to the treasury stock method under GAAP.

For our reporting segments, operating profit increased in Europe and Asia Pacific in the three month period ended March 31, 2014 compared to the same prior year period, while in the Americas it decreased. The decrease in the Americas was primarily from lower gross profit due to the medical device excise tax and from lower average selling prices. In Europe, the increase in operating profit was driven by a 6 percent increase in sales coupled with controlled operating expenses. Operating expenses increased 2 percent, due to our operational excellence initiatives and the nature of fixed versus variable expenses resulting in operating margin expansion in Europe. The increase in operating profit in Asia Pacific was driven by an 8 percent increase in sales from volume/mix. While changes in foreign currency exchange rates decreased sales in Asia Pacific by 8 percent, this decline was largely offset by hedge gains recorded in 2014 versus hedge losses recorded in 2013.

***Non-GAAP operating performance measures***

We use financial measures that differ from financial measures determined in accordance with GAAP to evaluate our operating performance. These non-GAAP financial measures exclude the impact of inventory step-up, certain inventory and manufacturing related charges connected to quality enhancement and remediation efforts, “Special items,” and any related effects on our income tax provision associated with these items. 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 month period ended March 31, 2014 was \$258.1 million compared to \$240.8 million in the same prior year period. Our non-GAAP adjusted diluted earnings per share for the three month period ended March 31, 2014 was \$1.50, compared to \$1.41 in the same prior year period.

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 used for internal management purposes.

<u>(In millions)</u>	<b>Three Months Ended March 31,</b>	
	<u>2014</u>	<u>2013</u>
Net Earnings of Zimmer Holdings, Inc. . . . .	\$221.5	\$218.6
Inventory step-up and other inventory and manufacturing related charges . . . . .	7.7	2.2
Special items . . . . .	45.9	33.5
Taxes on above items* . . . . .	<u>(17.0)</u>	<u>(13.5)</u>
Adjusted Net Earnings . . . . .	<u>\$258.1</u>	<u>\$240.8</u>

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

	<b>March 31,</b>	
	<u>2014</u>	<u>2013</u>
Diluted EPS . . . . .	\$ 1.29	\$ 1.28
Inventory step-up and other inventory and manufacturing related charges . . . . .	0.04	0.01
Special items . . . . .	0.27	0.20
Taxes on above items* . . . . .	<u>(0.10)</u>	<u>(0.08)</u>
Adjusted Diluted EPS . . . . .	<u>\$ 1.50</u>	<u>\$ 1.41</u>

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

## Liquidity and Capital Resources

Cash flows provided by operating activities were \$188.8 million in the three month period ended March 31, 2014, compared to \$180.5 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 \$114.7 million of operating cash in the 2014 period. All other items of operating cash flows reflect a use of \$147.0 million of cash in the three month period ended March 31, 2014, compared to a use of \$137.4 million in the same 2013 period.

The higher cash flows provided by operating activities in the 2014 period were primarily due to improved cash flows generated from receivables collections, especially significant amounts received in Spain, and lower funding of our U.S. pension plans. These favorable items were partially offset by higher tax payments for certain unresolved matters in order to limit the potential impact of IRS interest charges.

At March 31, 2014, we had 68 days of sales outstanding in trade accounts receivable, which represents an increase of 3 days compared to December 31, 2013 and is the same as March 31, 2013. At March 31, 2014, we had 334 days of inventory on hand. This is an increase of 49 days compared to December 31, 2013 and an increase of 15 days from March 31, 2013. We consider the changes in days of sales outstanding and days of inventory on hand as normal fluctuations for our business.

Cash flows used in investing activities were \$98.4 million in the three month period ended March 31, 2014, compared to cash inflows of \$53.0 million in the same prior year period. Additions to instruments were relatively consistent between the 2014 and 2013 periods as we continued to purchase instruments for significant product launches, such as *Persona* The Personalized Knee System. Spending on other property, plant and equipment increased in the 2014 period compared to the 2013 period, reflecting cash outlays necessary to complete new product-related investments and to replace older machinery and equipment. We invest some of 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. The timing of these investments can vary from quarter to quarter depending on the maturity of the debt securities and other cash and cash equivalent needs.

Cash flows used in financing activities were \$290.7 million in the three month period ended March 31, 2014, compared to \$452.5 million in the same prior year period. In the 2014 period, we returned cash to our stockholders in the form of cash dividends of \$34.0 million and share repurchases of \$400.5 million. In the 2013 period, we paid off outstanding borrowings under our senior credit facility. Additionally, an increase in our stock price in late 2013 and into 2014 resulted in many employees exercising stock options, which provided us with additional cash.

In February 2014, our Board of Directors declared a cash dividend of \$0.22 per share that was paid in April 2014. We expect to continue paying cash dividends on a quarterly basis; however, future dividends are subject to approval of the Board of Directors and may be adjusted as business needs or market conditions change. The first quarter 2014 dividend equates to an annual rate of \$0.88 per share, which represents a 10 percent increase over the 2013 annualized rate.

As discussed in Note 11 to the interim condensed consolidated financial statements included in Part I, Item 1 of this report, the IRS has issued proposed adjustments for years 2006 through 2009 reallocating profits between certain of our U.S. and foreign subsidiaries. We have disputed these proposed adjustments and continue to pursue resolution with the IRS. Although the ultimate timing for resolution of the disputed tax issues is uncertain, future payments may be significant to our operating cash flows.

As discussed in Note 15 to the interim condensed consolidated financial statements included in Part I, Item 1 of this report, we are defending a patent infringement lawsuit in which the trial court awarded the plaintiff \$210.0 million in damages plus interest and attorneys' fees. We have filed a Notice of Appeal and have not recorded a liability because we do not believe it is probable that we have incurred a loss. Although we believe we have strong grounds to reverse the trial court's judgment, we could be required to pay \$210.0 million plus interest and attorneys' fees in the future.

Also as discussed in Note 15 to the interim condensed consolidated financial statements included in Part I, Item 1 of this report, we have recorded a short-term liability of \$50.0 million and long-term liability of \$322.3 million related to *Durom* Cup product liability claims. We expect to continue paying these claims over

the next five years. We have also recorded a long-term receivable of \$218.0 million that we expect to receive from insurance carriers once we reach our self-insured retention under our insurance programs.

As discussed in Note 16 to the interim condensed consolidated financial statements included in Part I, Item 1 of this report, we have entered into a definitive agreement to merge with Biomet's parent corporation for \$10.35 billion in cash and 32.7 million shares of our common stock which had an aggregate value of \$3.0 billion, based on the stock price at the time of the announcement of the transaction. We expect to fund the cash portion of the purchase price with existing cash on hand, as well as proceeds obtained from a newly committed \$3.0 billion senior unsecured term loan and senior notes we intend to issue. In connection with our execution of the definitive agreement, in April 2014 we entered into a \$7.66 billion 364-day bridge facility (Bridge Facility), which we intend to reduce when the new senior notes are issued.

Currently, we have four tranches of senior notes outstanding: \$250 million aggregate principal amount of 1.4 percent notes due November 30, 2014, \$500 million aggregate principal amount of 4.625 percent notes due November 30, 2019, \$300 million aggregate principal amount of 3.375 percent notes due November 30, 2021 and \$500 million aggregate principal amount of 5.75 percent notes due November 30, 2039. Interest on each series 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 15 basis points in the case of the 2014 notes, 20 basis points in the case of the 2019 and 2021 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 intend to refinance our \$250 million senior notes due November 30, 2014 by either borrowing against our senior credit facility or by issuing new senior notes.

We have a five year \$1,350 million revolving, multi-currency, senior unsecured credit facility maturing May 9, 2017 (Senior Credit Facility). There were no borrowings outstanding under the Senior Credit Facility at March 31, 2014. Due to the pending Biomet transaction, we expect to renew the Senior Credit Facility later this year.

We and certain of our wholly owned foreign subsidiaries are the borrowers under the Senior Credit Facility. Borrowings under the Senior Credit Facility bear interest at a LIBOR-based rate plus an applicable margin determined by reference to our senior unsecured long-term credit rating and the amounts drawn under the Senior Credit Facility, at an alternate base rate, or at a fixed-rate determined through a competitive bid process. The Senior Credit Facility contains customary affirmative and negative covenants and events of default for an unsecured financing arrangement, including, among other things, limitations on consolidations, mergers and sales or transfers of assets. Financial covenants include a maximum leverage ratio of 3.0 to 1.0. If we fall below an investment grade credit rating, additional restrictions would result, including restrictions on investments, payment of dividends and stock repurchases. We were in compliance with all covenants under the Senior Credit Facility as of March 31, 2014. Commitments under the Senior Credit Facility are subject to certain fees, including a facility fee and a utilization fee.

We have a term loan agreement (Term Loan) with one of the lenders under the Senior Credit Facility for 11.7 billion Japanese Yen that will mature on May 31, 2016. Borrowings under the Term Loan bear interest at a fixed rate of 0.61 percent per annum until maturity.

We also have available uncommitted credit facilities totaling \$50.3 million. The Bridge Facility we entered into in connection with the Biomet transaction will provide up to \$7.66 billion for 364 days.

We expect to maintain an investment grade credit ratings by Standard and Poor's and Moody's if the Biomet transaction is completed. After the announcement of the Biomet transaction, Standard and Poor's Ratings Services placed a CreditWatch with negative implications on our rating and expects to lower our rating from A- to BBB if the transaction is completed. Moody's Investor Services placed our rating on review for downgrade and expects to lower our rating from Baa1 to Baa3 if the transaction is completed.



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 March 31, 2014, we had short-term and long-term investments in debt securities with a fair value of \$823.9 million. These investments are in debt securities of many different issuers and therefore we believe we have no significant concentration of risk with a single issuer. All of these debt securities remain highly-rated and we believe the risk of default by the issuers is low.

As of March 31, 2014, \$786.6 million of our cash and cash equivalents and short-term and long-term investments were held in jurisdictions outside of the U.S. and are expected to be indefinitely reinvested for continued use in foreign operations. Repatriation of these assets to the U.S. may have tax consequences. \$462.1 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.

Our concentration of credit risks with respect to trade accounts receivable is limited due to the large number of customers and their dispersion across a number of geographic areas, and by frequent monitoring of the creditworthiness of the customers to whom credit is granted in the normal course of business. Substantially all of our trade receivables are concentrated in the public and private hospital and healthcare industry in the U.S. and internationally or with distributors or dealers who operate in international markets and, accordingly, are exposed to their respective business, economic and country specific variables.

Our ability to collect accounts receivable in some countries depends in part upon the financial stability of these hospital and healthcare sectors and the respective countries' national economic and healthcare systems. Most notably, in Europe healthcare is typically sponsored by the government. Since we sell products to public hospitals in those countries, we are indirectly exposed to government budget constraints. The ongoing financial uncertainties in the Euro zone impact the indirect credit exposure we have to those governments through their public hospitals. As of March 31, 2014, in Greece, Italy, Portugal and Spain, countries that have been widely recognized as presenting the highest risk, our gross short-term and long-term trade accounts receivable combined were \$211.1 million. With allowances for doubtful accounts of \$9.9 million recorded in those countries, the net balance was \$201.2 million, representing 23 percent of our total consolidated short-term and long-term trade accounts receivable balance, net. Italy and Spain accounted for \$193.5 million of that net amount. We are actively monitoring the situations in these countries. We maintain contact with customers in these countries on a regular basis. We continue to receive payments, albeit at a slower rate than in the past. We believe our allowance for doubtful accounts is adequate in these countries, as ultimately we believe the governments in these countries will be able to pay. To the extent the respective governments' ability to fund their public hospital programs deteriorates, we may have to record significant bad debt expenses in the future.

As of March 31, 2014, \$599.5 million remained authorized under our \$1.0 billion share repurchase program, which has no expiration date. Due to the pending transaction with Biomet, we do not plan to repurchase additional shares in 2014, in order to preserve capital to help fund the transaction. Upon completion of the transaction, in the near to medium term we intend to use our cash flows for debt repayment and dividends instead of share repurchases.

Management believes that cash flows from operations and available borrowings under the Senior Credit Facility or from the public and private debt markets are sufficient to meet our working capital, capital expenditure, debt service needs and fund our pending transaction with Biomet, as well as return cash to stockholders in the form of dividends. Should additional 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.

### **Critical Accounting Estimates**

There were no changes in the three month period ended March 31, 2014 to the application of critical accounting policies as described in our Annual Report on Form 10-K for the year ended December 31, 2013. As

discussed in that Annual Report on Form 10-K, our annual impairment test of goodwill occurs in the fourth quarter every year. In our 2013 impairment test, while no impairment charges were recorded, we concluded that our U.S. Spine and U.S. Dental reporting units' estimated fair values did not substantially exceed their respective carrying values. If these reporting units are not able to achieve their operating plans or if those markets deteriorate beyond our expectations, we may have to record a goodwill impairment charge in the future. We have other reporting units with goodwill assigned to them. As of the annual impairment test in 2013, the estimated fair values for those reporting units substantially exceeded their carrying values.

### **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:

- the possibility that the anticipated synergies and other benefits from our proposed merger (the “Merger”) with Biomet will not be realized, or will not be realized within the expected time periods;
- the inability to obtain regulatory approvals of the Merger (including the approval of antitrust authorities necessary to complete the transaction) on the terms desired or anticipated;
- the timing of such regulatory approvals and the risk that such approvals may result in the imposition of conditions that could adversely affect the combined company or the expected benefits of the Merger;
- the risk that a condition to closing the Merger may not be satisfied on a timely basis or at all, and the risk that the proposed transaction fails to close for any other reason;
- the risks and uncertainties related to our ability to successfully integrate Biomet’s operations, products, employees and distributors with ours;
- the effect of the potential disruption of management’s attention from ongoing business operations due to the Merger;
- the effect of the announcement of the proposed Merger on our relationships and Biomet’s relationships with our respective customers, vendors and lenders and on our respective operating results and businesses generally;
- the risk that any condition to the closing of the financing committed for the Merger and the refinancing of our debt is not satisfied on a timely basis or at all;
- the outcome of any legal proceedings related to the proposed Merger;
- competition;
- pricing pressures;
- the impact of the federal healthcare reform measures, including the impact of the U.S. 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 (FDA) and foreign government regulators, such as more stringent requirements for regulatory clearance of our products;
- our ability to remediate matters identified in any inspectional observations or warning letters issued by the FDA;
- the success of our quality and operational excellence initiatives;

- changes in tax obligations arising from tax reform measures or examinations by tax authorities;
- 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;
- 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 and intellectual property litigation losses;
- our ability to obtain and maintain adequate intellectual property protection;
- our ability to retain the independent agents and distributors who market our products;
- our dependence on a limited number of suppliers for key raw materials and outsourced activities;
- the possible disruptive effect of additional strategic acquisitions and our ability to successfully integrate acquired companies;
- our ability to form and implement alliances;
- the impact of the ongoing financial uncertainty on countries in the Euro zone on our ability to collect accounts receivable in affected countries;
- changes in prices of raw materials and products and our ability to control costs and expenses; 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, 2013 and this Quarterly Report on Form 10-Q contain discussions of these and other important factors under the heading “Risk Factors.” 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, 2013.

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

**Evaluation of Disclosure Controls and Procedures**

We maintain disclosure controls and procedures (as defined in Rule 13a-15(e) under 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 March 31, 2014 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, Item 1 of this report.

### Item 1A. *Risk Factors*

Other than the addition of the risk factors presented below related to our proposed Biomet transaction, there have been no material changes in the risk factors previously disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013.

***We may not realize all of the anticipated benefits of the Biomet merger or those benefits may take longer to realize than expected. We may also encounter significant unexpected difficulties in integrating the two businesses.***

The success of the merger will depend, in part, on our ability to realize the anticipated benefits and cost savings from combining the businesses of Zimmer and Biomet. Zimmer and Biomet have operated and, until the completion of the merger, will continue to operate, independently. It is possible that the integration process could result in the loss of key employees or distributors, the disruption of each company's ongoing businesses or inconsistencies in standards, controls, procedures and policies that could adversely affect the combined company's ability to maintain relationships with customers or suppliers, or to achieve the anticipated benefits of the merger. If we experience difficulties with the integration process, the anticipated synergies and other benefits of the transaction may not be realized fully or at all, or may take longer to realize than expected. Integration efforts between the two companies may also divert management attention and resources. These integration matters could have an adverse effect on each of Zimmer and Biomet during this transition period and for an undetermined period after completion of the transaction on the combined company.

In addition, even if we successfully integrate Biomet's business operations with our own, we may not realize the full expected benefits of the transaction, including the synergies, cost savings, sales and growth opportunities that we expect. These benefits may not be achieved within the anticipated time frame, or at all. Additional unanticipated costs may also be incurred in the integration of the companies' businesses. As a result, we cannot assure you that the combination of Zimmer's and Biomet's businesses will result in the realization of the full synergies and other benefits anticipated from the transaction.

***Zimmer and Biomet will be subject to business uncertainties while the transaction is pending that may have an adverse effect on Zimmer prior to closing or the combined company after completion of the transaction.***

Uncertainty about the effect of the transaction between Zimmer and Biomet on employees, distributors, customers and suppliers may have an adverse effect on the parties prior to closing or the combined company after completion of the transaction. These uncertainties may impair Zimmer's or Biomet's ability to attract, retain and motivate key personnel until the transaction is completed, and could cause customers, suppliers and others that deal with Zimmer or Biomet to seek to change existing business relationships with either company. If key employees or distributors depart because of issues relating to the uncertainty and difficulty of integration or a desire not to remain with Zimmer or Biomet, Zimmer's business or the business of the combined company after completion of the transaction could be harmed.

***Failure to consummate the Biomet transaction could negatively impact our share price and our future business and financial results.***

If the proposed Biomet transaction is not consummated, our ongoing businesses may be adversely affected and, without realizing any of the benefits of having consummated the transaction, we will be subject to a number of risks, including the following:

- if the merger agreement is terminated under specified circumstances, we may be required to pay to Biomet a termination fee equal to \$800.0 million;

- matters relating to the transaction (including integration planning) may require substantial commitments of time and resources by our management, which could otherwise have been devoted to pursuing other opportunities that may have been beneficial to us;
- the market price of our common stock could decline to the extent that the current market price reflects an assumption that the transaction will be completed;
- we have incurred and will incur substantial expenses in connection with the negotiation and completion of the transaction, and if the transaction is not completed, we would have recognized these expenses without realizing the expected benefits of the transaction; and
- we could be subject to litigation related to any failure to consummate the merger or related to any enforcement proceeding commenced against us to perform our respective obligations under the merger agreement.

If the merger is not consummated, these risks may materialize and may materially adversely affect our business, financial results and share price.

***If we consummate the Biomet transaction, we will be required to incur a substantial amount of additional indebtedness and issue equity securities, which could have an adverse effect on our financial health and make it more difficult for us to obtain additional financing in the future.***

We currently expect to fund the \$13.35 billion purchase price for the Biomet transaction with a combination of \$3 billion of equity and \$10.35 billion of cash and debt. The increased indebtedness and higher debt-to-equity ratio we will experience could, among other things, limit our ability to obtain financing in the future, reduce our flexibility to respond to changing business and economic conditions and increase our borrowing costs. Furthermore, the issuance of equity securities may result in substantial dilution to our existing stockholders and may have a material adverse effect on the market price of our common stock. Additionally, if we fail to realize the expected benefits from the Biomet transaction or if the financial performance of the combined company does not meet our current expectations, it may make it more difficult for us to service our debt and our results of operations may fail to meet expectations.

Consummation of the transaction is not subject to a financing condition. We may have to obtain financing under the bridge facility if we cannot secure the permanent financing we currently expect to obtain. The interest rates, mandatory prepayment provisions and other terms and covenants for debt incurred pursuant to the bridge facility would generally be less favorable than the permanent financing arrangements that we contemplate.

***The required regulatory approvals to complete the Biomet transaction may not be obtained or may contain materially burdensome conditions that could have a material adverse effect on us.***

Completion of the Biomet transaction is conditioned upon the receipt of certain governmental approvals, including, without limitation, the expiration or termination of the applicable waiting period under the Hart-Scott Rodino Antitrust Improvements Act of 1976, as amended, the approval of the European Commission pursuant to applicable antitrust laws and, with respect to certain other jurisdictions, the receipt of regulatory approval or the termination or expiration of applicable waiting periods. Although Zimmer and Biomet have agreed in the merger agreement to take all steps necessary to obtain the requisite antitrust governmental approvals, there can be no assurance that these approvals will be obtained. In addition, the governmental authorities from which these approvals are required may impose conditions on the completion of the transaction or require changes to the terms of the transaction including, without limitation, the sale or divestiture of assets or businesses and the entering into, amendment or termination of contracts or other arrangements. If we are required to divest assets or businesses, there can be no assurance that we will be able to negotiate such divestitures expeditiously or on favorable terms or that the governmental authorities will approve the terms of such divestitures. If we become subject to any material conditions in order to obtain any approvals required to complete the transaction, completion of the transaction could be delayed and our business and results of operations may be materially adversely affected.

***Biomet faces litigation risks and is the subject of various legal proceedings, which the combined company would assume if the transaction is consummated.***

If we consummate the Biomet transaction, the combined company will assume Biomet’s risks arising from legal proceedings. Like all medical device companies in the current legal environment, Biomet is involved in various patent, product liability, consumer and commercial litigation and claims, government investigations, and other legal proceedings that arise from time to time in the ordinary course of its business. We cannot predict with certainty the eventual outcome of Biomet’s pending or future legal proceedings and the ultimate outcome of such matters could be material to our results of operations, cash flows and financial condition.

**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 March 31, 2014:

	<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>
January 2014 . . . . .	1,059,320	\$93.62	1,059,320	\$900,825,809
February 2014 . . . . .	1,830,000	94.00	1,830,000	728,807,991
March 2014 . . . . .	1,345,200	96.10	1,345,200	599,534,755
Total . . . . .	<u>4,234,520</u>	<u>\$94.57</u>	<u>4,234,520</u>	<u>\$599,534,755</u>

\* Includes repurchases made under the current program authorizing \$1.0 billion of repurchases. The current program has no expiration date. However, due to the pending transaction with Biomet, we do not plan on further share repurchases in the near to medium term.

**Item 3. *Defaults Upon Senior Securities***

None

**Item 4. *Mine Safety Disclosures***

Not applicable

**Item 5. *Other Information***

During the three month period ended March 31, 2014, the Audit Committee of our Board of Directors approved the engagement of PricewaterhouseCoopers LLP, our independent registered public accounting firm, to perform certain 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:

- |         |                                                                                                                                                                                                |
|---------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.1    | Separation Agreement between Zimmer, Inc. and Jeffery A. McCaulley entered into on January 28, 2014                                                                                            |
| 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                                                                                                                                           |

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: May 6, 2014

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

Date: May 6, 2014

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

P.O. Box 708  
Warsaw, IN 46581-0708  
574 267-6131



**Confidential**

January 10, 2014

Jeffery A. McCaulley

Dear Jeff:

This will confirm the termination of your employment by Zimmer, effective January 10, 2014. This letter and the attached material summarize important issues regarding severance and other benefits you may be eligible to receive as a result of your separation.

**SEVERANCE**

Zimmer's standard severance benefit includes an amount representing a number of weeks of base pay based on years of service and an amount equal to the cost of continued health insurance coverage ("COBRA coverage") for a certain number of weeks after your current coverage ends. Under the Zimmer Holdings, Inc. Restated Severance Plan ("Severance Plan"), dated March 2013, you would be eligible, subject to the terms of the Severance Plan, for a severance benefit of 7.5 weeks of base pay, which would equal \$79,326.92, plus 7.5 weeks of COBRA subsidy, which would equal \$2,217.41, for a total benefit of \$81,989.66. Based upon your separation date, you would also be eligible, again subject to the terms of the Severance Plan, to receive the value of the bonus you would have received under Zimmer's Executive Performance Incentive Plan had you remained employed on the payout date.

In the interest of a mutually respectful parting of ways, and taking into account your senior executive status, Zimmer is willing to offer you an enhanced severance benefit as an exception to our policy and in lieu of the standard benefit under the Severance Plan. This enhanced severance offer totals six months of base pay, which equals \$275,000, plus six months of COBRA subsidy, which equals \$8,520.78, for a total severance offer of \$283,520.78. It also includes payment of a 2013 bonus calculated in accordance with Zimmer's Executive Performance Incentive Plan based upon your eligible earnings for 2013 and final bonus metric for 2013. Additionally, it includes up to \$25,000 in outplacement services reimbursement as further explained below. The \$283,520.78 will be paid to you in a lump sum, less applicable tax withholdings, as soon as administratively feasible following receipt of the executed General Release that is attached and expiration of a seven-day rescission period, assuming you do not rescind the General Release within that period. The 2013 bonus equivalent will be paid to you, less applicable tax withholdings, in or around March 2014, again subject to receipt of an executed General Release without a timely rescission. This enhanced benefit will be provided to you in accordance with, and subject to, terms and provisions of the Severance Plan, with the sole exceptions from Severance Plan terms and provisions being the benefit amount, the timing of payment of the 2013 bonus equivalent, and provisions specific to the outplacement services benefit enhancement.



Although the COBRA component is intended to help you with the costs of maintaining health insurance coverage after your separation from employment, it is not restricted as to use and if you fulfill all conditions of receiving severance benefits as described below, you may use that monetary sum as you see fit. Also, you must still timely complete and return the COBRA enrollment form, and pay premiums to maintain this coverage.

#### **ATTACHMENT I — GENERAL RELEASE**

You must sign and not rescind the General Release in order to qualify for any severance benefit. Please read this attachment carefully, and consult with an attorney and/or any other advisor of your choice prior to signing the General Release. In summary, by signing the General Release, you waive all legal claims against Zimmer and its affiliates through the date of your signing, to the fullest extent permitted by law. Certain rights under the Zimmer Holdings, Inc. 2006 and 2009 Stock Incentive Plans, if applicable, are also contingent upon your executing the General Release. You have 21 calendar days from the date of this letter to review, consider, sign and return the General Release, and 7 calendar days thereafter to revoke your signature. Should you revoke the General Release within the time allowed, you will forego any severance benefits as well as any unvested Zimmer Holdings, Inc. 2006 and 2009 Stock Incentive Plan stock options.

#### **OUTPLACEMENT SERVICES**

Zimmer will provide you with certain outplacement services to assist you in transitioning to other employment, in an amount not to exceed \$25,000. The services will be provided by Right Management. You may contact Right Management at 1-800-966-6880 or via email at [rightindianapolis@right.com](mailto:rightindianapolis@right.com). If you prefer to use a different resource, subject to your signing and not timely rescinding the attached General Release, Zimmer will make an exception to its policy and either pay on your behalf or reimburse you for up to \$25,000 in outplacement services expense that you incur within six months of your separation date from Zimmer. Any such payment or reimbursement will be reported as taxable income to you and will be subject to applicable tax withholdings.

#### **ATTACHMENT II — VACATION PAY SUMMARY**

You will receive payment for any unused and earned vacation. If applicable, payment will be made in a lump sum as soon as administratively feasible following your separation date in accordance with applicable state law.

#### **ATTACHMENT III — TERMINATION OF BENEFIT COVERAGES**

Group medical, dental and vision benefits, if applicable, end as of 11:59 p.m. on the last calendar day of the month during which your employment terminates. All other benefits terminate as of 11:59 p.m. on your last day of employment. If you have elected a flexible spending account (FSA), expenses incurred after your last day of active employment are not reimbursable from your FSA unless you are eligible for and timely elect applicable COBRA coverage. Shortly following your termination date, detailed information concerning medical care continuation options that are available to you as a result of your termination of employment will be mailed to your home, as provided by the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"). Attachment III sets forth a summary of COBRA premiums, which are subject to change.

You must elect COBRA coverage in accordance with the instructions that will be sent to you, and pay all applicable premiums as instructed, to continue medical care coverage. As explained above, although the severance benefit you are being offered includes an amount intended to subsidize your COBRA premiums for a period of time, it is up to you to decide whether or not to use that money for payment of COBRA premiums. Zimmer will not enroll you for COBRA coverage or make any COBRA payments on your behalf.

Please note that, as long as you are eligible for benefits under Zimmer's medical plans or dental plan, you will also continue to be eligible to participate in the Employee Assistance Program. Plan benefits are explained more fully in the summary plan description.

Life and Accidental Death and Dismemberment (AD&D) insurance coverage will terminate as of 11:59 p.m. on your last day of active employment. You will have the opportunity to convert or port a portion of your life insurance benefit into an individual policy as described in Attachment IV, which is an excerpt from the Life Insurance and AD&D Insurance Programs Summary Plan Description. Information regarding this opportunity will be sent to you from the Zimmer Benefit Service Center. If you have not received that information within 15 days from the date of this letter, please contact the Service Center at 1-877-588-0933. You must elect to convert or port your insurance coverage in a timely manner to qualify for individual-policy coverage.

#### **SAVINGS AND INVESTMENT PROGRAM (401(k))**

You are fully vested in both your Employee and Employer account balances. Within four to six weeks following your termination date, you will receive important information from Fidelity describing your options as an inactive participant in the 401(k) Program.

#### **BENEFIT EQUALIZATION PLAN OF THE SAVINGS AND INVESTMENT PROGRAM (BEP-SAVINGS PLAN)**

You elected to participate in the BEP-Savings Plan, which is a non-qualified plan. As with the 401(k) Program, you are fully vested in both your Employee and Employer account balances. Your estimated vested account balance as of September 30, 2013 is \$122,003.

Because you are an officer of Zimmer and considered a Specified Employee under Section 409A as of your separation date, your vested account balance as of your separation date will be paid to you in a lump sum, less applicable taxes, on the first payroll period date after six months have elapsed from your date of separation. We expect that the payment date will be August 1, 2014.

Your BEP-Savings Plan account balance as of September 30, 2013 shown above will be adjusted for investment experience through June 30, 2014. You will continue to receive quarterly Statements of Account providing you with updated account balance information. Please note that, because this is a non-qualified plan, the distribution may not be rolled into an IRA or other qualified plan.

Payment of your BEP-Savings Plan account balance will be automatic, so there is no action you must take to initiate payment.

As noted above, the amount of your benefit payment from the BEP-Savings Plan is considered ordinary income and subject to applicable income tax withholding.

You have been paying applicable Social Security and Medicare taxes on your BEP-Savings Plan deferrals and Company match during each payroll period. Therefore, we do not expect that there will be any additional Social Security and Medicare taxes due on the amount to be distributed to you. Federal, State and Local taxes will be withheld from the distribution.

## **STOCK OPTIONS**

You have vested stock options that were granted under the 2006 and/or 2009 Stock Incentive Plans and you are not eligible for retiree treatment. Consequently, you will have three months from your separation date to exercise your vested stock options. In addition, you have unvested stock options that were granted under the 2006 and/or 2009 Stock Incentive Plans that you have held for at least one year as of the date of your termination of employment. In accordance with the applicable Award Agreements, if you sign and do not timely rescind the General Release, Zimmer will accelerate the vesting of these options and you will have three months from your separation date to exercise these options. *Any stock options that you do not exercise within three months of your separation date, including stock options that are not "in-the-money," will expire. We are unable to extend this 90 day period of time.*

Please remember, under the Zimmer Stock Trading Policy, because you are a "Covered Person" under the policy and you are terminating service with Zimmer during a quarterly blackout period, you may not trade in Zimmer securities until the second business day after the quarterly earnings release. It is anticipated that Zimmer's Fourth Quarter 2013 earnings release will be on Thursday, January 30, 2014, meaning the blackout period would expire at 12:01 a.m. on Monday, February 3, 2014. As these dates are subject to change, you should follow Zimmer press releases to confirm the earnings release date. Please note that the fact that you are subject to the current blackout period does not serve to extend the three-month period during which you may exercise vested stock options. After expiration of the current blackout period, you will not be subject to any future quarterly blackout periods.

Further, you currently have in place a Rule 10b5-1 Plan. Section 4(d) of that plan prohibits you from selling shares (including cashless exercises of stock options) outside the plan prior to termination of the plan. However, you may opt to terminate the plan at any time upon written notice to Computershare. Jan Zolman can assist in providing any such notice to Computershare.

### **RESTRICTED STOCK UNIT AWARDS (RSUs)**

With respect to RSUs granted to you prior to 2012, you will receive a pro-rata number (as applicable) of RSUs that you have held for at least one year in accordance with the applicable Award Agreement(s).

Your 2012 and 2013 performance-based RSUs tied to three-year iTSR performance will be cancelled.

Please contact Jan Zolman, Stock Option Administrator, at (574) 372-4185 if you have any questions regarding your stock options or RSUs.

### **CONFIDENTIALITY**

Please remember your continuing obligation to maintain confidentiality and not use or disclose any information concerning Zimmer's business or affairs that is not public knowledge. This obligation, which you acknowledged and agreed to in the non-disclosure, non-competition and non-solicitation agreement that you signed, continues after the termination of your employment. This means, among other things, that in addition to any restrictions already existing by law, you are contractually prohibited from disclosing or using Zimmer's confidential, proprietary, and trade secret information.

Because you are a Named Executive Officer (i.e., an officer named in the Summary Compensation Table of Zimmer's most recent proxy statement), the material terms of your enhanced severance benefit will be described in a Form 8-K filed with the Securities and Exchange Commission within four business days of your execution of the General Release.

### **NON-DISCLOSURE, NON-COMPETITION AND NON-SOLICITATION AGREEMENT**

Given that your employment with Zimmer is terminating, we remind you of your continuing obligations under your non-disclosure, non-competition and non-solicitation agreement ("Agreement") with Zimmer. In the Agreement, you promised not to engage in certain competitive activities for the period set forth in the Agreement and not to disparage Zimmer. We request that you be mindful of your continuing obligations under the Agreement and that you strictly comply with them. Please understand that if you do not comply fully with your legal obligations under the Agreement, Zimmer will take all necessary actions to enforce its legal rights, including the forfeiture or clawback of any option and severance benefits. We trust, however, that you will honor your obligations under the Agreement and that no further action or communication on this subject will be necessary.

Should you receive an offer of employment that would or might violate the restrictions in your Agreement, or be advised that you would receive an offer but for the restrictions in your Agreement, please let us know promptly. We will then determine whether Zimmer is willing to release you from restrictions under your Agreement to the extent necessary to allow you to accept the opportunity. We may require information sufficient to verify the opportunity. If Zimmer does not provide such a waiver of restrictions, you may qualify for non-competition

period payments under the Agreement. Such payments would commence after your six-month severance benefit period ends, and continue through the end of your restricted period under the Agreement subject to your fulfilling requirements for continued payments set forth in the Agreement.

### **COMPANY PROPERTY**

To the extent you still have in your possession or control any Zimmer property or any materials (including, without limitation, documents, electronic data, computers, PDA's, cell phones or files in your possession, or any copies thereof) containing any of Zimmer's confidential, proprietary, or trade secret information, please immediately deliver all such property to me or coordinate with me regarding the return of such materials.

You must also delete any electronic confidential Zimmer information stored on your personal computer or other electronic device.

### **SUMMARY**

This letter is intended to summarize the benefits to which you may be entitled as a result of your separation from Zimmer. Your benefits are governed by the terms of each applicable plan document and/or award agreement, and if there is a conflict, the terms of the plan document will control (with the exceptions related to your enhanced severance offer as described above). For your reference, we have included a list of service providers and contact information for Zimmer benefit programs (Attachment V).

Please note that although the severance benefit you are being offered should not be subject to Section 409A of the Internal Revenue Code of 1986, as amended, Zimmer does not guarantee any tax consequences related to any benefit under severance or non-qualified plans.

Please notify me promptly of any address changes, so that we can ensure that all communication and tax information is directed to the correct address. If you have any questions concerning this letter or any of the arrangements surrounding your separation from the Company, please feel free to contact me.

Sincerely,

/s/ Bill B. Fisher

Bill P. Fisher  
Senior Vice President, Global Human Resources

#### Attachments:

Attachment I - General Release /Attachment II - Vacation Pay Worksheet

Attachment III - COBRA Rates

Attachment IV - Excerpt from Life Insurance and AD&D Insurance Programs Summary Plan Description, Regarding Portability and Conversion

Attachment V - Vendor Contact Information

**CERTIFICATION PURSUANT TO RULE 13a-14(a)/15d-14(a) OF THE SECURITIES EXCHANGE ACT OF 1934, AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, David C. Dvorak, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Zimmer Holdings, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 6, 2014

/s/ David C. Dvorak

David C. Dvorak  
*President and Chief Executive Officer*

**CERTIFICATION PURSUANT TO RULE 13a-14(a)/15d-14(a) OF THE SECURITIES EXCHANGE ACT OF 1934, AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, James T. Crines, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Zimmer Holdings, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 6, 2014

/s/ James T. Crines

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James T. Crines  
*Executive Vice President, Finance and Chief  
Financial Officer*



**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Zimmer Holdings, Inc. (the “Company”) on Form 10-Q for the period ending March 31, 2014 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), each of the undersigned certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ David C. Dvorak

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David C. Dvorak  
*President and Chief Executive Officer*  
May 6, 2014

/s/ James T. Crines

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James T. Crines  
*Executive Vice President, Finance and Chief  
Financial Officer*  
May 6, 2014