

CERNER CORP /MO/
Form 10-Q
October 24, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended: September 27, 2014

OR

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

For the transition period from _____ to _____

Commission File Number: 0-15386

CERNER CORPORATION

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

2800 Rockcreek Parkway

North Kansas City, MO

(Address of principal executive offices)

(816) 201-1024

(Registrant's telephone number, including area code)

43-1196944

(I.R.S. Employer Identification
Number)

64117

(Zip Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes 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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

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

Class

Outstanding at October 17, 2014

Common Stock, \$0.01 par value per share

341,472,242 shares

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CERNER CORPORATION

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Part I. Financial Information

Item 1. Financial Statements

CERNER CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

As of September 27, 2014 (unaudited) and December 28, 2013

(In thousands, except share data)

	2014	2013
Assets		
Current assets:		
Cash and cash equivalents	\$496,494	\$202,377
Short-term investments	835,269	677,004
Receivables, net	617,204	582,926
Inventory	28,604	32,299
Prepaid expenses and other	181,103	175,488
Deferred income taxes, net	76,803	91,614
Total current assets	2,235,477	1,761,708
Property and equipment, net	889,487	792,781
Software development costs, net	402,772	347,077
Goodwill	322,135	307,422
Intangible assets, net	131,790	144,132
Long-term investments	226,371	554,873
Other assets	184,606	190,371
Total assets	\$4,392,638	\$4,098,364
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	\$169,227	\$145,019
Current installments of long-term debt and capital lease obligations	60,042	54,107
Deferred revenue	215,528	209,746
Accrued payroll and tax withholdings	145,739	147,986
Other accrued expenses	80,584	83,574
Total current liabilities	671,120	640,432
Long-term debt and capital lease obligations	86,756	111,717
Deferred income taxes and other liabilities	229,450	170,392
Deferred revenue	9,102	8,159
Total liabilities	996,428	930,700
Shareholders' Equity:		
Common stock, \$.01 par value, 500,000,000 shares authorized, 346,052,087 shares issued at September 27, 2014 and 344,338,030 shares issued at December 28, 2013	3,461	3,443
Additional paid-in capital	890,902	812,853
Retained earnings	2,770,609	2,393,048
	(245,333)	(28,251)

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Treasury stock, 4,652,515 shares at September 27, 2014 and 570,616 shares at December 28, 2013

Accumulated other comprehensive loss, net	(23,429)	(13,429)
Total shareholders' equity	3,396,210		3,167,664	
Total liabilities and shareholders' equity	\$4,392,638		\$4,098,364	

See notes to condensed consolidated financial statements (unaudited).

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CERNER CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

For the three and nine months ended September 27, 2014 and September 28, 2013

(unaudited)

(In thousands, except per share data)	Three Months Ended		Nine Months Ended	
	2014	2013	2014	2013
Revenues:				
System sales	\$224,345	\$202,632	\$665,595	\$602,037
Support, maintenance and services	593,068	508,520	1,738,664	1,461,723
Reimbursed travel	22,736	16,678	72,413	51,660
Total revenues	840,149	727,830	2,476,672	2,115,420
Costs and expenses:				
Cost of system sales	65,520	64,389	211,939	217,580
Cost of support, maintenance and services	51,809	38,510	147,181	103,366
Cost of reimbursed travel	22,736	16,678	72,413	51,660
Sales and client service	346,417	304,665	1,020,552	853,213
Software development (Includes amortization of \$25,372 and \$75,410 for the three and nine months ended September 27, 2014; and \$24,056 and \$69,366 for the three and nine months ended September 28, 2013)	97,026	82,998	285,897	246,343
General and administrative	68,487	51,352	180,900	150,995
Total costs and expenses	651,995	558,592	1,918,882	1,623,157
Operating earnings	188,154	169,238	557,790	492,263
Other income, net	2,181	3,509	7,908	9,286
Earnings before income taxes	190,335	172,747	565,698	501,549
Income taxes	(61,333)	(57,403)	(188,137)	(163,258)
Net earnings	\$129,002	\$115,344	\$377,561	\$338,291
Basic earnings per share	\$0.38	\$0.34	\$1.10	\$0.98
Diluted earnings per share	\$0.37	\$0.33	\$1.08	\$0.96
Basic weighted average shares outstanding	341,188	342,992	342,254	343,681
Diluted weighted average shares outstanding	349,326	351,449	350,468	352,332
See notes to condensed consolidated financial statements (unaudited).				

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CERNER CORPORATION AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
 For the three and nine months ended September 27, 2014 and September 28, 2013
 (unaudited)

(In thousands)	Three Months Ended		Nine Months Ended	
	2014	2013	2014	2013
Net earnings	\$129,002	\$115,344	\$377,561	\$338,291
Foreign currency translation adjustment and other (net of tax benefit of \$922 and \$603 for the three and nine months ended September 27, 2014; and \$1,366 and \$1,984 for the three and nine months ended September 28, 2013)	(17,672)	10,595	(9,603)	(7,610)
Unrealized holding gain (loss) on available-for-sale investments (net of taxes (benefit) of \$(259) and \$(252) for the three and nine months ended September 27, 2014; and \$509 and \$(34) for the three and nine months ended September 28, 2013)	(409)	801	(397)	(59)
Comprehensive income	\$110,921	\$126,740	\$367,561	\$330,622

See notes to condensed consolidated financial statements (unaudited).

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CERNER CORPORATION AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
 For the nine months ended September 27, 2014 and September 28, 2013
 (unaudited)

(In thousands)	Nine Months Ended	
	2014	2013
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net earnings	\$377,561	\$338,291
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	217,212	189,460
Share-based compensation expense	43,330	33,650
Provision for deferred income taxes	21,712	19,573
Changes in assets and liabilities (net of businesses acquired):		
Receivables, net	(36,562)	41,281
Inventory	3,515	(3,887)
Prepaid expenses and other	9,862	(48,290)
Accounts payable	20,137	(19,309)
Accrued income taxes	(2,038)	(6,404)
Deferred revenue	7,361	5,440
Other accrued liabilities	(38,511)	4,580
Net cash provided by operating activities	623,579	554,385
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital purchases	(200,372)	(218,406)
Capitalized software development costs	(130,761)	(125,951)
Purchases of investments	(1,069,938)	(832,039)
Sales and maturities of investments	1,224,063	825,126
Purchase of other intangibles	(10,238)	(39,797)
Acquisition of businesses, net of cash acquired	(7,476)	(67,877)
Net cash used in investing activities	(194,722)	(458,944)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of long-term debt and capital lease obligations	(75)	(9,756)
Proceeds from excess tax benefits from share-based compensation	26,079	29,274
Proceeds from exercise of options	19,423	24,049
Treasury stock purchases	(217,082)	(170,042)
Contingent consideration payments for acquisition of businesses	(10,617)	(800)
Cash grants	48,000	—
Other	2,894	4,823
Net cash used in financing activities	(131,378)	(122,452)
Effect of exchange rate changes on cash and cash equivalents	(3,362)	(2,589)
Net increase (decrease) in cash and cash equivalents	294,117	(29,600)
Cash and cash equivalents at beginning of period	202,377	317,120

Cash and cash equivalents at end of period	\$496,494	\$287,520
Summary of acquisition transactions:		
Fair value of net tangible assets acquired	\$(1,509)	\$1,512
Fair value of intangible assets acquired	3,800	25,489
Fair value of goodwill	16,785	60,511
Less: Fair value of contingent liability payable	(11,600)	(18,982)
Cash paid for acquisitions	7,476	68,530
Cash acquired	—	(653)
Net cash used	\$7,476	\$67,877
See notes to condensed consolidated financial statements (unaudited).		

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CERNER CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(1) Interim Statement Presentation

The condensed consolidated financial statements included herein have been prepared by Cerner Corporation (Cerner, the Company, we, us or our) without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) have been condensed or omitted pursuant to such rules and regulations. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in our latest annual report on Form 10-K.

In management's opinion, the accompanying unaudited condensed consolidated financial statements include all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position and the results of operations and cash flows for the periods presented. Our interim results as presented in this Form 10-Q are not necessarily indicative of the operating results for the entire year.

The condensed consolidated financial statements were prepared using GAAP. These principles require us to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities and the reported amounts of revenues and expenses. Actual results could differ from those estimates.

Our third fiscal quarter ends on the Saturday closest to September 30. The 2014 and 2013 third quarters ended on September 27, 2014 and September 28, 2013, respectively. All references to years in these notes to condensed consolidated financial statements represent the respective three or nine months ended on such dates, unless otherwise noted.

Available-for-sale Investments

Our short-term investments are primarily invested in time deposits, commercial paper, government and corporate bonds, with maturities of less than one year. Our long-term investments are primarily invested in government and corporate bonds with maturities of less than two years.

Recently Issued Accounting Pronouncements

Revenue Recognition. In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. This new guidance is effective for the Company in the first quarter of 2017, with no early adoption permitted. The standard permits the use of either the retrospective or cumulative effect transition method. At this time we have not selected a transition method. We are currently evaluating the effect that ASU 2014-09 will have on our consolidated financial statements and related disclosures.

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(2) Business Acquisitions

Siemens Health Services

On August 5, 2014, we entered into a Master Sale and Purchase Agreement (the "Agreement") with Siemens AG, a stock corporation under the laws of Germany ("Siemens"), pursuant to which Cerner will acquire substantially all of the assets, and assume certain liabilities of Siemens' health information technology business unit, Siemens Health Services.

Consideration for this acquisition is expected to total \$1.3 billion in cash, subject to certain adjustments for working capital and pension obligations. We expect to enter into a transition services agreement pursuant to which Siemens will provide certain transitional services to Cerner for an initial period of up to six months after the acquisition closing.

In September 2014, the U.S. Federal Trade Commission granted early termination of the waiting period under the Hart-Scott-Rodino (HSR) Antitrust Improvements Act of 1976, as amended, in connection with our purchase of Siemens Health Services. The early termination of the HSR waiting period satisfies one of the conditions to closing of the pending acquisition. The transaction remains subject to other customary closing conditions and is expected to close in our first fiscal quarter of 2015.

Concurrently with the execution of the Agreement, the parties entered into an agreement to create a strategic alliance to jointly invest in innovative projects that integrate health IT with medical technologies for the purpose of enhancing workflows and improving clinical outcomes. After closing, each company will contribute up to \$50.0 million to fund projects of shared importance to both companies and their clients.

During the three months ended September 27, 2014, we incurred \$9.4 million of costs in connection with our pending acquisition of Siemens Health Services, which are included in general and administrative expense in our condensed consolidated statements of operations.

InterMedHx

On April 1, 2014, we purchased 100% of the outstanding membership interests of InterMedHx, LLC (InterMedHx). InterMedHx is a provider of health technology solutions in the areas of preventive care, patient administration, and medication history. We believe the addition of InterMedHx solutions provides additional capabilities in the market.

Consideration for the acquisition of InterMedHx is expected to total \$19.1 million consisting of up-front cash plus contingent consideration, which is payable at a percentage of the revenue contribution from InterMedHx solutions and services. We valued the contingent consideration at \$11.6 million based on projections of revenue over the assessment period.

The allocation of purchase price to the estimated fair value of the identified tangible and intangible assets acquired and liabilities assumed resulted in goodwill of \$16.8 million and \$3.8 million in intangible assets related to the value of existing technologies. The goodwill was allocated to our Domestic operating segment and is expected to be deductible for tax purposes. Identifiable intangible assets are being amortized over a period of five years.

The operating results of InterMedHx were combined with our operating results subsequent to the purchase date of April 1, 2014. Pro-forma results of operations have not been presented because the effect of this acquisition was not material to our results.

(3) Fair Value Measurements

We determine fair value measurements used in our consolidated financial statements based upon the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value hierarchy distinguishes between (1) market participant assumptions developed based on market data obtained from independent sources (observable inputs) and (2) an entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The fair value hierarchy consists of three broad levels, which gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). The three levels of the fair value hierarchy are described below:

• Level 1 – Valuations based on quoted prices in active markets for identical assets or liabilities that the entity has the ability to access.

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Level 2 – Valuations based on quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable data for substantially the full term of the assets or liabilities.

Level 3 – Valuations based on inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The following table details our financial assets measured and recorded at fair value on a recurring basis at September 27, 2014:

(In thousands)

Description	Balance Sheet Classification	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
Money market funds	Cash equivalents	\$213,003	\$—	\$—
Time deposits	Cash equivalents	—	11,354	—
Commercial paper	Cash equivalents	—	62,575	—
Government and corporate bonds	Cash equivalents	—	2,500	—
Time deposits	Short-term investments	—	83,395	—
Commercial paper	Short-term investments	—	441,365	—
Government and corporate bonds	Short-term investments	—	310,509	—
Government and corporate bonds	Long-term investments	—	213,704	—

The following table details our financial assets measured and recorded at fair value on a recurring basis at December 28, 2013:

(In thousands)

Description	Balance Sheet Classification	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
Money market funds	Cash equivalents	\$57,254	\$—	\$—
Time deposits	Cash equivalents	—	7,771	—
Commercial paper	Cash equivalents	—	3,000	—
Government and corporate bonds	Cash equivalents	—	410	—
Time deposits	Short-term investments	—	70,315	—
Commercial paper	Short-term investments	—	33,742	—
Government and corporate bonds	Short-term investments	—	572,947	—
Government and corporate bonds	Long-term investments	—	542,711	—

We estimate the fair value of our long-term, fixed rate debt using a Level 3 discounted cash flow analysis based on current borrowing rates for debt with similar maturities. The fair value of our long-term debt, including current maturities, at September 27, 2014 and December 28, 2013 was approximately \$33.3 million and \$32.6 million, respectively. The carrying amount of such fixed-rate debt at September 27, 2014 and December 28, 2013 was \$30.2 million and \$30.6 million, respectively.

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(4) Investments

Available-for-sale investments at September 27, 2014 were as follows:

(In thousands)	Adjusted Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Cash equivalents:				
Money market funds	\$213,003	\$ —	\$ —	\$213,003
Time deposits	11,354	—	—	11,354
Commercial paper	62,575	—	—	62,575
Government and corporate bonds	2,500	—	—	2,500
Total cash equivalents	289,432	—		