

ILLUMINA INC
Form 10-Q
May 07, 2014
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the Quarterly Period Ended March 30, 2014

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 001-35406
Illumina, Inc.
(Exact name of registrant as specified in its charter)

Delaware 33-0804655
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

5200 Illumina Way, 92122
San Diego, CA (Zip Code)
(Address of principal executive offices)
(858) 202-4500
(Registrant's telephone number, including area 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 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 (Do not check if a smaller reporting company) 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 11, 2014, there were 128.4 million shares of the registrant's Common Stock outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

ILLUMINA, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

	March 30, 2014 (Unaudited)	December 29, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	\$518,513	\$711,637
Short-term investments	573,289	453,966
Accounts receivable, net	293,045	238,946
Inventory	164,231	154,099
Deferred tax assets, current portion	40,349	36,076
Prepaid expenses and other current assets	42,516	22,811
Total current assets	1,631,943	1,617,535
Property and equipment, net	210,372	202,666
Goodwill	723,259	723,061
Intangible assets, net	316,984	331,173
Deferred tax assets, long-term portion	101,336	88,480
Other assets	69,676	56,091
Total assets	\$3,053,570	\$3,019,006
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$86,471	\$73,655
Accrued liabilities	215,292	219,120
Long-term debt, current portion	848,016	29,288
Total current liabilities	1,149,779	322,063
Long-term debt	—	839,305
Long-term legal contingencies	138,780	132,933
Other long-term liabilities	191,398	191,221
Conversion option subject to cash settlement	—	282
Stockholders' equity:		
Preferred stock	—	—
Common stock	1,778	1,753
Additional paid-in capital	2,681,983	2,562,705
Accumulated other comprehensive income	1,208	1,234
Retained earnings	267,832	207,855
Treasury stock, at cost	(1,379,188)	(1,240,345)
Total stockholders' equity	1,573,613	1,533,202
Total liabilities and stockholders' equity	\$3,053,570	\$3,019,006
See accompanying notes to the condensed consolidated financial statements.		

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ILLUMINA, INC.
 CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
 (Unaudited)
 (In thousands, except per share amounts)

	Three Months Ended		
	March 30, 2014	March 31, 2013	
Revenue:			
Product revenue	\$362,211	\$296,170	
Service and other revenue	58,570	34,788	
Total revenue	420,781	330,958	
Cost of revenue:			
Cost of product revenue	111,441	89,978	
Cost of service and other revenue	21,513	15,138	
Amortization of acquired intangible assets	9,535	6,550	
Total cost of revenue	142,489	111,666	
Gross profit	278,292	219,292	
Operating expense:			
Research and development	77,041	61,450	
Selling, general and administrative	109,573	85,074	
Acquisition related (gain) expense, net	(1,013	) 3,821
Headquarter relocation	595	757	
Legal contingencies	—	105,853	
Unsolicited tender offer related expense	—	7,484	
Total operating expense	186,196	264,439	
Income (loss) from operations	92,096	(45,147)
Other income (expense):			
Interest income	956	1,933	
Interest expense	(9,743) (9,747)
Cost-method investment related gain	—	6,113	
Other income (expense), net	479	(714)
Total other expense, net	(8,308) (2,415)
Income (loss) before income taxes	83,788	(47,562)
Provision for (benefit from) income taxes	23,811	(24,975)
Net income (loss)	\$59,977	\$(22,587)
Net income (loss) per basic share	\$0.47	\$(0.18)
Net income (loss) per diluted share	\$0.40	\$(0.18)
Shares used in calculating basic net income (loss) per share	128,146	123,768	
Shares used in calculating diluted net income (loss) per share	150,619	123,768	
See accompanying notes to the condensed consolidated financial statements.			

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ILLUMINA, INC.
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
 (Unaudited)
 (In thousands)

	Three Months Ended	
	March 30, 2014	March 31, 2013
Net income (loss)	\$59,977	\$(22,587)
Unrealized loss on available-for-sale securities, net of deferred tax	(26)	(420)
Total comprehensive income (loss)	\$59,951	\$(23,007)

See accompanying notes to the condensed consolidated financial statements.

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ILLUMINA, INC.
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
 (Unaudited)
 (In thousands)

	Three Months Ended	
	March 30, 2014	March 31, 2013
Cash flows from operating activities:		
Net income (loss)	\$59,977	\$(22,587)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation expense	14,593	11,759
Amortization of intangible assets	13,814	8,772
Share-based compensation expense	33,424	24,219
Accretion of debt discount	8,992	9,009
Contingent compensation expense	2,417	1,393
Incremental tax benefit related to share-based compensation	(50,528)	(5,278)
Deferred income taxes	33,943	(36,704)
Change in fair value of contingent consideration	(1,760)	464
Cost-method investment related gain	—	(6,113)
Other	(636)	4,107
Changes in operating assets and liabilities:		
Accounts receivable	(52,156)	6,129
Inventory	(9,991)	(8,266)
Prepaid expenses and other current assets	125	1,536
Other assets	(8,972)	(2,088)
Accounts payable	10,060	8,459
Accrued liabilities	(23,147)	(15,267)
Accrued legal contingencies	5,847	106,922
Other long-term liabilities	1,085	1,374
Net cash provided by operating activities	37,087	87,840
Cash flows from investing activities:		
Purchases of available-for-sale securities	(253,255)	(97,480)
Sales of available-for-sale securities	89,030	278,181
Maturities of available-for-sale securities	44,075	111,333
Net cash paid for acquisitions	—	(345,111)
(Purchases of) sales proceeds from strategic investments	(4,600)	9,998
Purchases of property and equipment	(19,012)	(21,441)
Cash paid for intangible assets	(625)	(501)
Net cash used in investing activities	(144,387)	(65,021)
Cash flows from financing activities:		
Payments on financing obligations	(29,654)	(58)
Payments on acquisition related contingent consideration liability	—	(3,985)
Incremental tax benefit related to share-based compensation	50,528	5,278
Common stock repurchases	(130,017)	(25,011)
Taxes paid related to net share settlement of equity awards	(8,826)	(2,468)
Proceeds from issuance of common stock	32,045	13,238
Net cash used in financing activities	(85,924)	(13,006)
Effect of exchange rate changes on cash and cash equivalents	100	(712)

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Net (decrease) increase in cash and cash equivalents	(193,124) 9,101
Cash and cash equivalents at beginning of period	711,637	433,981
Cash and cash equivalents at end of period	\$518,513	\$443,082

See accompanying notes to the condensed consolidated financial statements.

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Illumina, Inc.

Notes to Condensed Consolidated Financial Statements
(Unaudited)

Unless the context requires otherwise, references in this report to “Illumina,” “we,” “us,” the “Company,” and “our” refer to Illumina, Inc. and its consolidated subsidiaries.

1. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. The unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany transactions and balances have been eliminated in consolidation. In management’s opinion, the accompanying financial statements reflect all adjustments, consisting of normal recurring adjustments, considered necessary for a fair presentation of the results for the interim periods presented.

Interim financial results are not necessarily indicative of results anticipated for the full year. These unaudited condensed consolidated financial statements should be read in conjunction with the Company’s audited consolidated financial statements and footnotes included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 29, 2013, from which the balance sheet information herein was derived.

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expense, and related disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

Segment Information

Effective December 30, 2013, the Company reorganized and separated the roles of the Chief Executive Officer and the President, with core market and operational functions centralized and reporting to the President for the primary purpose of achieving scalability in business operations to support the growth in its strategic markets. Corporate functions and the President report to the CEO. As a result, the Company operates under one operating segment and reports under one reportable segment.

Fiscal Year

The Company’s fiscal year consists of 52 or 53 weeks ending the Sunday closest to December 31, with quarters of 13 or 14 weeks ending the Sunday closest to March 31, June 30, September 30, and December 31. The three months ended March 30, 2014 and March 31, 2013 were both 13 weeks.

Derivatives

The Company is exposed to foreign exchange rate risks in the normal course of business. To manage a portion of the accounting exposure resulting from changes in foreign currency exchange rates, the Company enters into foreign exchange contracts to hedge monetary assets and liabilities that are denominated in currencies other than the U.S. dollar. These foreign exchange contracts are carried at fair value and are not designated as hedging instruments. Changes in the value of the derivative are recognized in other expense, net, along with an offsetting remeasurement

gain or loss on the underlying foreign currency denominated assets or liabilities.

As of March 30, 2014, the Company had foreign exchange forward contracts in place to hedge exposures in the euro, Japanese yen, and Australian dollar. As of March 30, 2014 and December 29, 2013, the total notional amounts of outstanding forward contracts in place for foreign currency purchases were approximately \$74.7 million and \$54.7 million, respectively.

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Reserve for Product Warranties

The Company generally provides a one-year warranty on instruments. Additionally, the Company provides a warranty on consumables through the expiration date, which generally ranges from six to twelve months after the manufacture date. At the time revenue is recognized, the Company establishes an accrual for estimated warranty expenses based on historical experience as well as anticipated product performance. The Company periodically reviews the adequacy of its warranty reserve and adjusts the warranty accrual, if necessary, based on actual experience and estimated costs to be incurred. Warranty expense is recorded as a component of cost of product revenue.

Revenue Recognition

The Company's revenue is generated primarily from the sale of products and services. Product revenue primarily consists of sales of instruments and consumables used in genetic analysis. Service and other revenue primarily consists of revenue generated from genotyping and sequencing services and instrument service contracts.

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the seller's price to the buyer is fixed or determinable, and collectibility is reasonably assured. In instances where final acceptance of the product or system is required, revenue is deferred until all the acceptance criteria have been met. All revenue is recorded net of any discounts.

Revenue from product sales is recognized generally upon transfer of title to the customer, provided that no significant obligations remain and collection of the receivable is reasonably assured. Revenue from instrument service contracts is recognized as the services are rendered, typically evenly over the contract term. Revenue from genotyping and sequencing services is recognized when earned, which is generally at the time the genotyping or sequencing analysis data is made available to the customer or agreed upon milestones are reached.

In order to assess whether the price is fixed or determinable, the Company evaluates whether refund rights exist. If there are refund rights or payment terms based on future performance, the Company defers revenue recognition until the price becomes fixed or determinable. The Company assesses collectibility based on a number of factors, including past transaction history with, and the creditworthiness of, the customer. If the Company determines that collection of a payment is not reasonably assured, revenue recognition is deferred until receipt of payment.

The Company regularly enters into contracts where revenue is derived from multiple deliverables including products or services. These products or services are generally delivered within a short time frame, approximately three to six months, after the contract execution date. Revenue recognition for contracts with multiple deliverables is based on the individual units of accounting determined to exist in the contract. A delivered item is considered a separate unit of accounting when the delivered item has value to the customer on a stand-alone basis. Items are considered to have stand-alone value when they are sold separately by any vendor or when the customer could resell the item on a stand-alone basis. Consideration is allocated at the inception of the contract to all deliverables based on their relative selling price. The relative selling price for each deliverable is determined using vendor specific objective evidence (VSOE) of selling price or third-party evidence of selling price if VSOE does not exist. If neither VSOE nor third-party evidence exists, the Company uses its best estimate of the selling price for the deliverable.

In order to establish VSOE of selling price, the Company must regularly sell the product or service on a standalone basis with a substantial majority priced within a relatively narrow range. VSOE of selling price is usually the midpoint of that range. If there are not a sufficient number of standalone sales and VSOE of selling price cannot be determined, then the Company considers whether third party evidence can be used to establish selling price. Due to the lack of similar products and services sold by other companies within the industry, the Company has rarely established selling price using third-party evidence. If neither VSOE nor third party evidence of selling price exists, the Company

determines its best estimate of selling price using average selling prices over a rolling 12-month period coupled with an assessment of current market conditions. If the product or service has no history of sales or if the sales volume is not sufficient, the Company relies upon prices set by the Company's pricing committee adjusted for applicable discounts. The Company recognizes revenue for delivered elements only when it determines there are no uncertainties regarding customer acceptance.

In certain markets, the Company sells products and provides services to customers through distributors that specialize in life science products. In most sales through distributors, the product is delivered directly to customers. In cases where the product is delivered to a distributor, revenue recognition is deferred until acceptance is received from the distributor, and/or the end-user, if required by the applicable sales contract. The terms of sales transactions through distributors are consistent with

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the terms of direct sales to customers. These transactions are accounted for in accordance with the Company's revenue recognition policy described herein.

Net Income (Loss) per Share

Basic net income (loss) per share is computed based on the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is computed based on the sum of the weighted average number of common shares and dilutive potential common shares outstanding during the period.

Dilutive potential common shares consist of shares issuable under convertible senior notes, equity awards, and warrants. Convertible senior notes have a dilutive impact when the average market price of the Company's common stock exceeds the applicable conversion price of the respective notes. Potentially dilutive common shares from equity awards and warrants are determined using the average share price for each period under the treasury stock method. In addition, the following amounts are assumed to be used to repurchase shares: proceeds from exercise of equity awards and warrants; the average amount of unrecognized compensation expense for equity awards; and estimated tax benefits that will be recorded in additional paid-in capital when the expenses related to equity awards become deductible. In loss periods, basic net loss per share and diluted net loss per share are identical because the otherwise dilutive potential common shares become anti-dilutive and are therefore excluded.

The following table presents the calculation of weighted average shares used to calculate basic and diluted net income (loss) per share (in thousands):

	Three Months Ended	
	March 30, 2014	March 31, 2013
Weighted average shares outstanding	128,146	123,768
Effect of dilutive potential common shares from:		
Convertible senior notes	5,518	—
Equity awards	4,816	—
Warrants	12,139	—
Weighted average shares used in calculation of diluted net income (loss) per share	150,619	123,768
Potentially dilutive shares excluded from calculation due to anti-dilutive effect	124	32,942

2. Balance Sheet Account Details

Short-Term Investments

The following is a summary of short-term investments (in thousands):

	March 30, 2014				December 29, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available-for-sale securities:								
Debt securities in government sponsored entities	\$81,077	\$26	\$(78)	) \$81,025	\$82,226	\$18	\$(101)	) \$82,143
Corporate debt securities	427,130	284	(427)	) 426,987	342,034	312	(376)	) 341,970
	65,211	70	(4)	) 65,277	29,795	58	—	) 29,853

U.S. Treasury
securities

Total

available-for-sale securities	\$573,418	\$380	\$(509)	\$573,289	\$454,055	\$388	\$(477)	\$453,966
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As of March 30, 2014, the Company had 118 available-for-sale securities in a gross unrealized loss position which had been in such position for less than twelve months. There were no impairments considered other-than-temporary as it is more likely than not the Company will hold the securities until maturity or the recovery of the cost basis. The following table shows the fair values and the gross unrealized losses of such available-for-sale securities that were in an unrealized loss position for less than twelve months as of March 30, 2014 and December 29, 2013, aggregated by investment category (in thousands):

	March 30, 2014		December 29, 2013	
	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses
Debt securities in government sponsored entities	\$53,076	\$(78)	) \$73,362	\$(101)
Corporate debt securities	197,841	(398)	) 168,118	(373)
U.S. Treasury securities	15,117	(4)) —	—
Total	\$266,034	\$(480)	) \$241,480	\$(474)

Realized gains and losses are determined based on the specific identification method and are reported in interest income.

Contractual maturities of available-for-sale debt securities as of March 30, 2014 were as follows (in thousands):

	Estimated Fair Value
Due within one year	\$204,870
After one but within five years	368,419
Total	\$573,289

Cost-Method Investments

As of March 30, 2014 and December 29, 2013, the aggregate carrying amounts of the Company's cost-method investments in non-publicly traded companies were \$26.7 million and \$22.1 million, respectively, which were included in other assets. During the three months ended March 31, 2013, the Company sold a cost-method investment and recognized a \$6.1 million gain. The Company's cost-method investments are assessed for impairment quarterly. No impairment loss was recorded during the three months ended March 30, 2014 or March 31, 2013. The Company does not reassess the fair value of cost-method investments if there are no identified events or changes in circumstances that may have a significant adverse effect on the fair value of the investments.

Headquarter Facility Exit Obligation

Changes in the Company's facility exit obligation related to its former headquarters lease during the three months ended March 30, 2014 and March 31, 2013 are as follows (in thousands):

	Three Months Ended	
	March 30, 2014	March 31, 2013
Balance at beginning of period	\$38,218	\$45,352
Additional facility exit obligation accrued	—	286
Accretion of interest expense	595	471
Cash payments	(1,633)) (2,201)

Balance at end of period	\$37,180	\$43,908
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Warranties

Changes in the Company's reserve for product warranties during the three months ended March 30, 2014 and March 31, 2013 are as follows (in thousands):

	Three Months Ended	
	March 30, 2014	March 31, 2013
Balance at beginning of period	\$ 10,407	\$ 10,136
Additions charged to cost of revenue	4,192	5,421
Repairs and replacements	(3,107	) (4,751
Balance at end of period	\$ 11,492	\$ 10,806

Inventory

Inventory consists of the following (in thousands):

	March 30, 2014	December 29, 2013
Raw materials	\$ 56,798	\$ 57,398
Work in process	78,742	70,016
Finished goods	28,691	26,685
Total inventory	\$ 164,231	\$ 154,099

Goodwill

Changes in the Company's goodwill balance during the three months ended March 30, 2014 are as follows (in thousands):

	Goodwill
Balance as of December 29, 2013	\$ 723,061
Purchase price allocation adjustments related to a prior year acquisition	198
Balance as of March 30, 2014	\$ 723,259

Accrued Liabilities

Accrued liabilities consist of the following (in thousands):

	March 30, 2014	December 29, 2013
Accrued compensation expenses	\$ 66,623	\$ 82,705
Deferred revenue, current portion	59,535	50,834
Accrued taxes payable	30,644	30,435
Customer deposits	14,312	13,569
Reserve for product warranties	11,492	10,407
Acquisition related contingent liability, current portion	6,950	6,719
Facility exit obligation, current portion	6,102	5,570
Other	19,634	18,881
Total accrued liabilities	\$ 215,292	\$ 219,120

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3. Acquisitions

2013 Acquisitions

On February 21, 2013, the Company acquired all of the outstanding capital stock of Verinata Health, Inc., a provider of non-invasive tests for the early identification of fetal chromosomal abnormalities. The aggregate purchase price was \$396.3 million, including total cash payment of \$339.3 million, \$56.2 million in fair value of the contingent milestone payments of up to \$100.0 million, \$0.2 million in fair value of converted stock options attributed to pre-combination services, and \$0.5 million in loss realized on settlement of preexisting relationships.

Assumptions used to estimate the acquisition date fair value of the contingent consideration included discount rates ranging from 6% to 20%, volatility of 50%, risk-free rate of 0.26%, revenue projections, and the probability of achieving regulatory milestones. This fair value measurement of the contingent consideration is based on significant inputs not observed in the market and thus represents a Level 3 measurement. Level 3 instruments are valued based on unobservable inputs that are supported by little or no market activity and reflect the Company's own assumptions in measuring fair value.

During 2013, the Company also completed acquisitions of Advanced Liquid Logic Inc., a provider of liquid handling solutions, NextBio, a provider of clinical and genomic informatics tools, and another development-stage company. As a result of these transactions, the Company recorded \$126.5 million in goodwill. The purchase price allocation for the NextBio acquisition is preliminary and subject to change as more detailed analyses are completed and additional information with respect to the fair values of the assets and liabilities acquired becomes available.

2012 Acquisition

On September 19, 2012, the Company announced the acquisition of BlueGnome Ltd., a provider of cytogenetics and in vitro fertilization screening products. Total consideration for the acquisition was \$95.5 million, which included \$88.0 million in initial cash payments and \$7.5 million in fair value of contingent cash consideration of up to \$20.0 million based on the achievement of certain revenue based milestones by December 28, 2014.

Summary of Contingent Compensation Expenses

Contingent compensation expenses recorded as a result of acquisitions consist of the following (in thousands):

	Three Months Ended	
	March 30, 2014	March 31, 2013
Contingent compensation, included in research and development expense	\$83	\$489
Contingent compensation, included in selling, general and administrative expense	2,756	2,929
Total contingent compensation expense	\$2,839	\$3,418

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4. Fair Value Measurements

The following table presents the Company's hierarchy for assets and liabilities measured at fair value on a recurring basis as of March 30, 2014 and December 29, 2013 (in thousands):

	March 30, 2014				December 29, 2013			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Assets:								
Money market funds (cash equivalents)	\$344,622	\$—	\$—	\$344,622	\$478,755	\$—	\$—	\$478,755
Debt securities in government-sponsored entities	—	81,025	—	81,025	—	82,143	—	82,143
Corporate debt securities	—	426,987	—	426,987	—	341,970	—	341,970
U.S. Treasury securities	65,277	—	—	65,277	29,853	—	—	29,853
Deferred compensation plan assets	—	21,580	—	21,580	—	17,805	—	17,805
Total assets measured at fair value	\$409,899	\$529,592	\$—	\$939,491	\$508,608	\$441,918	\$—	\$950,526
Liabilities:								
Acquisition related contingent consideration liabilities	\$—	\$—	\$47,720	\$47,720	\$—	\$—	\$49,480	\$49,480
Deferred compensation liability	—	18,236	—	18,236	—	14,957	—	14,957
Total liabilities measured at fair value	\$—	\$18,236	\$47,720	\$65,956	\$—	\$14,957	\$49,480	\$64,437

The Company holds available-for-sale securities that consist of highly liquid, investment grade debt securities. The Company considers information provided by the Company's investment accounting and reporting service provider in the measurement of fair value of its debt securities. The investment service provider provides valuation information from an industry-recognized valuation service. Such valuations may be based on trade prices in active markets for identical assets or liabilities (Level 1 inputs) or valuation models using inputs that are observable either directly or indirectly (Level 2 inputs), such as quoted prices for similar assets or liabilities, yield curve, volatility factors, credit spreads, default rates, loss severity, current market and contractual prices for the underlying instruments or debt, broker and dealer quotes, as well as other relevant economic measures. The Company's deferred compensation plan assets consist primarily of mutual funds. The Company performs control procedures to corroborate the fair value of its holdings, including comparing valuations obtained from its investment service provider to valuations reported by the Company's asset custodians, validation of pricing sources and models, and review of key model inputs if necessary.

The Company reassesses the fair value of contingent consideration to be settled in cash related to acquisitions on a quarterly basis using the income approach. This is a Level 3 measurement. Significant assumptions used in the measurement include probabilities of achieving the remaining milestones and the discount rates, which depend on the milestone risk profiles. The changes in the fair value of the contingent considerations during the three months ended March 30, 2014 were due to changes in the estimated payments and a shorter discounting period.

Changes in estimated fair value of contingent consideration liabilities during the three months ended March 30, 2014 are as follows (in thousands):

Contingent

	Consideration Liability (Level 3 Measurement)
Balance as of December 29, 2013	\$49,480
Change in estimated fair value, recorded in acquisition related (gain) expense, net	(1,760)
Balance as of March 30, 2014	\$47,720

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5. Convertible Senior Notes

0.25% Convertible Senior Notes due 2016

In 2011, the Company issued \$920.0 million aggregate principal amount of 0.25% convertible senior notes due 2016 (2016 Notes). The Company pays 0.25% interest per annum on the principal amount of the 2016 Notes semiannually in arrears in cash on March 15 and September 15 of each year. The 2016 Notes mature on March 15, 2016. The effective rate of the liability component was estimated to be 4.5%.

The 2016 Notes are convertible into cash, shares of common stock, or a combination of cash and shares of common stock, at the Company's election, based on an initial conversion rate, subject to adjustment, of 11.9687 shares per \$1,000 principal amount of the 2016 Notes (which represents an initial conversion price of approximately \$83.55 per share), only in the following circumstances and to the following extent: (1) during the five business-day period after any 10 consecutive trading day period (the "measurement period") in which the trading price per 2016 Note for each day of such measurement period was less than 98% of the product of the last reported sale price of the Company's common stock and the conversion rate on each such day; (2) during any calendar quarter (and only during that quarter) after the calendar quarter ending March 31, 2011, if the last reported sale price of the Company's common stock for 20 or more trading days in the period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter exceeds 130% of the applicable conversion price in effect on the last trading day of the immediately preceding calendar quarter; (3) upon the occurrence of specified events described in the indenture for the 2016 Notes; and (4) at any time on or after December 15, 2015 through the second scheduled trading day immediately preceding the maturity date. During the three months ended March 30, 2014 and March 31, 2013, the 2016 Notes were not convertible. Upon meeting the stock trading price conversion requirement during the three months ended March 30, 2014, the 2016 Notes became convertible on April 1, 2014 and continue to be convertible through June 30, 2014.

As noted in the indenture for the 2016 Notes, it is the Company's intent and policy to settle conversions through combination settlement, which essentially involves repayment of an amount of cash equal to the "principal portion" and delivery of the "share amount" in excess of the conversion value over the principal portion in shares of common stock. As a policy election under applicable guidance related to the calculation of diluted net income per share, the Company elected the combination settlement method as its stated settlement policy and applied the treasury stock method in the calculation of the dilutive impact of the 2016 Notes. The calculation of dilutive potential common shares outstanding for the three months ended March 30, 2014 reflects the dilutive impact from the 2016 Notes. If the 2016 Notes were converted as of March 30, 2014, the if-converted value would exceed the principal amount by \$817.8 million.

0.625% Convertible Senior Notes due 2014

In 2007, the Company issued \$400.0 million principal amount of 0.625% convertible senior notes due 2014 (2014 Notes) with a maturity date of February 15, 2014. The effective interest rate of the liability component was estimated to be 8.3%.

The 2014 Notes became convertible into cash and shares of the Company's common stock in various prior periods and became convertible again from April 1, 2012 through, and including, February 12, 2014. All notes were converted by February 12, 2014. In all cases of conversions of the 2014 Notes, the principal amount converted was repaid with cash and the excess of the conversion value over the principal amount was paid in shares of common stock. The equity dilution resulting from the issuance of common stock related to the conversion of the 2014 Notes was offset by repurchase of the same amount of shares under the convertible note hedge transactions, which were automatically exercised in accordance with their terms at the time of each conversion.

Upon conversion, the Company records losses on extinguishment of debt calculated as the difference between the estimated fair value of the debt and the carrying value of the notes as of the settlement dates. To measure the fair value of the converted notes as of the settlement dates, the applicable interest rates were estimated using Level 2 observable inputs and applied to the converted notes using the same methodology utilized for the issuance date valuation.

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The following table summarizes information about the conversions of the 2014 Notes during the three months ended March 30, 2014 (in thousands):

	2014 Notes
Cash paid for principal of notes converted	\$29,570
Conversion value over principal amount paid in shares of common stock	\$196,095
Number of shares of common stock issued upon conversion	1,151

The following table summarizes information about the equity and liability components of the 2014 Notes and 2016 Notes (dollars in thousands). The fair values of the respective notes outstanding were measured based on quoted market prices.

	March 30, 2014	December 29, 2013
Principal amount of convertible notes outstanding	\$920,000	\$949,570
Unamortized discount of liability component	(71,984)	(80,977)
Net carrying amount of liability component	848,016	868,593
Less: current portion	(848,016)	(29,288)
Long-term debt	\$—	\$839,305
Conversion option subject to cash settlement	—	\$282
Carrying value of equity component, net of debt issuance cost	\$155,366	\$274,304
Fair value of outstanding notes	\$1,635,903	\$1,428,743
Weighted average remaining amortization period of discount on the liability component	1.9 years	2.2 years

6. Share-based Compensation Expense

Share-based compensation expense for all stock awards consists of the following (in thousands):

	Three Months Ended	
	March 30, 2014	March 31, 2013
Cost of product revenue	\$2,095	\$1,442
Cost of service and other revenue	285	154
Research and development	11,669	8,006
Selling, general and administrative	19,375	14,617
Share-based compensation expense before taxes	33,424	24,219
Related income tax benefits	(10,577)	(7,565)
Share-based compensation expense, net of taxes	\$22,847	\$16,654

The assumptions used for the specified reporting periods and the resulting estimates of weighted-average fair value per share for stock purchased under the ESPP during the three months ended March 30, 2014 are as follows:

	Employee Stock Purchase Rights	
Risk-free interest rate	0.07 - 0.11%	
Expected volatility	38	%
Expected term	0.5 - 1.0 year	
Expected dividends	—	
Weighted average fair value per share	\$41.84	

As of March 30, 2014, approximately \$237.4 million of unrecognized compensation cost related to stock options, restricted stock, and ESPP shares granted to date is expected to be recognized over a weighted-average period of approximately 2.2 years.

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7. Stockholders' Equity

As of March 30, 2014, approximately 6.5 million shares remained available for future grants under the 2005 Stock Plan, the 2005 Solexa Equity Plan, and the 2008 Verinata Health Stock Plan.

Stock Options

The Company's stock option activity under all stock option plans during the three months ended March 30, 2014 is as follows:

	Options (in thousands)	Weighted-Average Exercise Price
Outstanding at December 29, 2013	5,724	\$32.64
Exercised	(875)	) \$25.94
Cancelled	(4)	) \$4.35
Outstanding at March 30, 2014	4,845	\$33.87

At March 30, 2014, outstanding options to purchase 4.0 million shares were exercisable with a weighted average exercise price per share of \$33.64.

Restricted Stock

A summary of the Company's restricted stock activity and related information for the three months ended March 30, 2014 is as follows:

	Restricted Stock Awards (RSA)	Restricted Stock Units (RSU)	Performance Stock Units (PSU)	Weighted Average Grant-Date Fair Value per Share		
				RSA	RSU	PSU
Outstanding at December 29, 2013	248	3,628	1,101	\$53.46	\$59.66	\$54.64
Awarded	—	222	187	—	\$141.49	\$147.30
Vested	(123)	) (409)	) —	\$47.90	\$50.82	—
Cancelled	—	(55)	(10)	—	\$53.79	\$49.04
Outstanding at March 30, 2014	125	3,386	1,278	\$55.44	\$66.21	\$68.24

Employee Stock Purchase Plan

The price at which common stock is purchased under the Employee Stock Purchase Plan (ESPP) is equal to 85% of the fair market value of the common stock on the first or last day of the offering period, whichever is lower. During the three months ended March 30, 2014, approximately 0.2 million shares were issued under the ESPP. As of March 30, 2014, there were approximately 14.8 million shares available for issuance under the ESPP.

Warrants

In connection with the offering of the 2014 Notes, the Company sold warrants to purchase 18.3 million shares of common stock to counterparties to the convertible note hedge transactions. The warrants have an exercise price of \$31.435 per share, and the proceeds from the sale of such warrants were used by the Company to partially offset the cost of the transactions. In July 2013, the Company settled with a hedging counterparty outstanding warrants to

purchase approximately 3.0 million shares of the Company's common stock for \$125.0 million in cash. As of March 30, 2014 warrants to purchase 15.4 million shares of the Company's common stock remained outstanding. All outstanding warrants will be exercised immediately prior to expiration, which occurs in equal installments during the 40 consecutive scheduled trading days beginning on May 16, 2014.

Share Repurchases

During the three months ended March 30, 2014 and March 31, 2013, the Company repurchased 0.8 million shares for \$130.0 million and 0.5 million shares for \$25.0 million, respectively.

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In April 2012 the Company's Board of Directors authorized share repurchases for up to \$250.0 million via a combination of Rule 10b5-1 and discretionary share repurchase programs. In addition, on January 30, 2014, the Company's Board of Directors authorized up to \$250.0 million to repurchase shares of the Company's common stock on a discretionary basis. Authorizations to repurchase up to an additional \$237.5 million of the Company's common stock remained as of March 30, 2014.

8. Income Taxes

The Company's effective tax rate may vary from the U.S. federal statutory tax rate due to the change in the mix of earnings in tax jurisdictions with different statutory rates, benefits related to tax credits, and the tax impact of non-deductible expenses and other permanent differences between income before income taxes and taxable income. The effective tax rate for the three months ended March 30, 2014 was 28.4%. The variance from the U.S. federal statutory tax rate of 35% was primarily attributable to a higher mix of foreign earnings, such as earnings in Singapore and the United Kingdom, taxed at rates lower than the U.S. federal statutory tax rate, and tax deductions related to stock award activities which were recorded as discrete items in the quarter. In 2013, the variance from the U.S. federal statutory tax rate was primarily attributable to a higher mix of foreign earnings taxed at rates lower than the U.S. federal statutory tax rate and the retroactive reinstatement of the federal research and development credit for 2012 which was enacted in January 2013.

In May 2013, the Internal Revenue Service began an audit of the Company's corporate income tax return filed for fiscal year 2011. The Internal Revenue Service continues to analyze the information provided by the Company and has not yet proposed any adjustments to the filed return.

9. Legal Proceedings

The Company is involved in various lawsuits and claims arising in the ordinary course of business, including actions with respect to intellectual property, employment, and contractual matters. In connection with these matters, the Company assesses, on a regular basis, the probability and range of possible loss based on the developments in these matters. A liability is recorded in the financial statements if it is believed to be probable that a loss has been incurred and the amount of the loss can be reasonably estimated. Because litigation is inherently unpredictable and unfavorable results could occur, assessing contingencies is highly subjective and requires judgments about future events. The Company regularly reviews outstanding legal matters to determine the adequacy of the liabilities accrued and related disclosures. The amount of ultimate loss may differ from these estimates. Each matter presents its own unique circumstances, and prior litigation does not necessarily provide a reliable basis on which to predict the outcome, or range of outcomes, in any individual proceeding. Because of the uncertainties related to the occurrence, amount, and range of loss on any pending litigation or claim, the Company is currently unable to predict their ultimate outcome, and, with respect to any pending litigation or claim where no liability has been accrued, to make a meaningful estimate of the reasonably possible loss or range of loss that could result from an unfavorable outcome. In the event that opposing litigants in outstanding litigations or claims ultimately succeed at trial and any subsequent appeals on their claims, any potential loss or charges in excess of any established accruals, individually or in the aggregate, could have a material adverse effect on the Company's business, financial condition, results of operations, and/or cash flows in the period in which the unfavorable outcome occurs or becomes probable, and potentially in future periods.

On November 24, 2010, Syntrix Biosystems, Inc. filed suit against the Company in the United States District Court for the Western District of Washington at Tacoma (Case No. C10-5870-BHS) alleging that the Company willfully infringed U.S. Patent No. 6,951,682 by selling its BeadChip array products, and that the Company misappropriated Syntrix's trade secrets. On January 30, 2013, the Court granted the Company's motion for summary judgment on Syntrix's trade secret claims, and dismissed those claims from the case. On March 14, 2013, a jury reached a verdict in favor of Syntrix, finding that Illumina's BeadChip kits infringe the Syntrix patent. During trial, the Court dismissed

Syntrix's claim that the alleged infringement was willful. On July 1, 2013, the Court entered a Final Amended Judgment for \$115.1 million, in accordance with the jury verdict, including supplemental damages and prejudgment interest. In addition, the Court awarded Syntrix an ongoing royalty of 8% for accused sales from March 15, 2013 until the patent expires on September 16, 2019. The Company believes that it did not infringe the Syntrix patent and that the patent is invalid. Therefore, the Company disagrees with the judgment and contends that the judgment is not supported by the law or facts. Accordingly, on December 3, 2013, the Company filed a Notice of Appeal to the Court of Appeals for the Federal Circuit challenging the Final Amended Judgment. On December 16, 2013, Syntrix cross appealed the Court's dismissal of its trade secret claims and denial of its willfulness claim.

As a result of the amended judgment, the Company recorded a legal contingency accrual of \$138.8 million and \$132.9 million as of March 30, 2014 and December 29, 2013, respectively, including damages and interest awarded to Syntrix. In the three months ended March 30, 2014, the Company recorded a related charge of \$5.8 million to cost of product revenue. In the three months ended March 31, 2013, the Company recorded charges of \$106.9 million, with \$105.9 million charged to

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operating expenses and the remainder to cost of product revenue. The judgment amount has been secured by a supersedeas bond, and as of March 30, 2014, \$17.8 million was deposited with the Court for the accrued post-judgment ongoing royalty amounts. The Company will continue to deposit with the Court ongoing royalties on future sales at the royalty rate stated in the Final Amended Judgment during the appeal process. Funds deposited with the Court are reported as restricted cash in other long-term assets.

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

Our Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) is provided in addition to the accompanying condensed consolidated financial statements and notes to assist readers in understanding our results of operations, financial condition, and cash flows. This MD&A is organized as follows:

Business Overview and Outlook. High level discussion of our operating results and significant known trends that affect our business.

Results of Operations. Detailed discussion of our revenues and expenses.

Liquidity and Capital Resources. Discussion of key aspects of our statements of cash flows, changes in our financial position, and our financial commitments.

Off-Balance Sheet Arrangements. We have no significant off-balance sheet arrangements.

Critical Accounting Policies and Estimates. Discussion of significant changes since our most recent Annual Report on Form 10-K that we believe are important to understanding the assumptions and judgments underlying our financial statements.

This MD&A discussion contains forward-looking statements that involve risks and uncertainties. Please see "Consideration Regarding Forward-Looking Statements" at the end of this MD&A section for additional factors relating to such statements. This MD&A should be read in conjunction with our condensed consolidated financial statements and accompanying notes included in this report and our Annual Report on Form 10-K for the fiscal year ended December 29, 2013. Operating results are not necessarily indicative of results that may occur in future periods.

Business Overview and Outlook

This overview and outlook provides a high level discussion of our operating results and significant known trends that affect our business. We believe that an understanding of these trends is important to understanding our financial results for the periods being reported herein as well as our future financial performance. This summary is not intended to be exhaustive, nor is it intended to be a substitute for the detailed discussion and analysis provided elsewhere in this Quarterly Report on Form 10-Q.

About Illumina

We are a leading developer, manufacturer, and marketer of life science tools and integrated systems for the analysis of genetic variation and function. Using our proprietary technologies, we provide innovative sequencing- and array-based solutions for genotyping, copy-number variation (CNV) analysis, methylation studies, and gene expression profiling of DNA and RNA. Our customers include leading genomic research centers, academic institutions, government laboratories, hospitals, and reference laboratories, as well as pharmaceutical, biotechnology, agrigenomics, commercial molecular diagnostic, and consumer genomics companies.

Our broad portfolio of instruments, consumables, and analysis tools are designed to simplify and accelerate genetic analysis. This portfolio addresses a broad range of genomic complexity, throughput, and price points, enabling customers to select the best solution for their scientific challenge. These systems can be used to efficiently perform a range of nucleic acid (DNA, RNA) analyses on large numbers of samples. For more focused studies, our array-based solutions provide ideal tools to perform genome-wide association studies (GWAS) involving single-nucleotide polymorphism (SNP) genotyping and (CNV) analyses, as well as gene expression profiling and other DNA and RNA studies.

To provide our customers with more comprehensive sample-to-answer workflow solutions, we acquired: NextBio, a leader in clinical and genomic informatics, in November 2013; Advanced Liquid Logic Inc., a leader in digital microfluidics and liquid handling solutions, in July 2013; and Epicentre Technologies Corporation, a leading provider of nucleic acid sample preparation reagents and specialty enzymes for sequencing and microarray applications, in 2011.

During the last two years, we have taken significant steps to support our goal of becoming a leader in the reproductive health market by acquiring Verinata Health, Inc. (Verinata) in February 2013 and BlueGnome Ltd. (BlueGnome) in 2012. Our acquisition of Verinata further strengthened our focus on reproductive health by adding to our product portfolio Verinata's verifi® prenatal test, a comprehensive non-invasive prenatal test (NIPT) for high-risk pregnancies. Our acquisition of BlueGnome, a leading provider of genetic solutions for the screening of chromosomal abnormalities associated with developmental delay, cancer, and infertility, expanded our ability to establish integrated solutions in reproductive health and cancer.

Our financial results have been, and will continue to be, impacted by several significant trends, which are described below. While these trends are important to understanding and evaluating our financial results, this discussion should be read in conjunction with our condensed consolidated financial statements and the notes thereto in Item 1, Part I of this report, and the other transactions, events, and trends discussed in "Risk Factors" in Item 1A, Part II of this report and Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 29, 2013.

Funding Environment

While many of our customers receive funding from government agencies to purchase our products or services, we are diversifying our customer base to include customers that do not depend on government funding. In 2013, approximately 45% of our total revenue came from customers who are not directly reliant on government agencies for funding. We estimate that less than 30% of our total revenue in 2013 came from academic or government customers in the United States that, directly or indirectly, derive funding from the U.S. National Institute of Health (NIH). NIH funding for the U.S. fiscal year 2014 increased more than 3% compared to the 2013 sequestration budget, and we believe that allocations within the NIH budget will continue to favor genetic analysis tools generally and, in particular, research programs that utilize next-generation sequencing.

Next-Generation Sequencing

Next-generation sequencing has become a core technology for modern life science research and is increasingly being used in the applied, molecular diagnostics, and translational markets. Our sequencing instrument installed base continued to expand in Q1 2014, and we believe that expansion of the sequencing market, including an increase in the number of samples available and enhancements in our product portfolio, will continue to drive demand for our next-generation sequencing technologies. As a result, we believe that our sequencing consumable revenue will continue to grow in future periods.

Our portfolio of sequencing platforms represents a family of systems that are designed to meet the workflow, output, and accuracy demands of a full range of sequencing applications. Our MiSeq sequencing system is a low-cost desktop platform that provides individual researchers with rapid turnaround time, high accuracy, and streamlined workflow.

NextSeq 500, launched in January 2014, provides flexibility from whole genome sequencing to targeted panels in a desktop platform. Our HiSeq 2500 sequencing system allows customers to sequence an entire human genome in approximately a day. HiSeq X Ten, announced in January 2014, is a set of ten ultra-high-throughput sequencers built for large-scale human whole-genome sequencing with the ability to generate 1.8 terabases of DNA sequence per sequencer in less than three days.

MicroArrays

As a complement to next-generation sequencing, we believe microarrays offer a less expensive, faster, and highly accurate technology for use when genetic content is already known. The information content of microarrays is fixed and reproducible. As such, microarrays provide repeatable, standardized assays for certain subsets of nucleotide bases within the overall genome. We believe that life science researchers will migrate certain array studies to sequencing; however, we expect this decline to be offset by demand from customers in consumer, reproductive health, and applied markets. Additionally, demand in the array market has trended toward microarrays that have large-sample numbers at a lower complexity, thus having a lower selling price per sample, and we believe our innovation in microarray products supports the lower selling price.

Financial Overview

Financial highlights for Q1 2014 include the following:

• Net revenue increased by 27.1% during Q1 2014 to \$420.8 million compared to Q1 2013. Our sales increased across our portfolio of sequencing products, including consumables, instruments, and services.

Gross profit as a percentage of revenue (gross margin) for Q1 2014 was 66.1% compared to 66.3% in Q1 2013. Gross margin in Q1 2014 decreased due to the negative impact of higher legal contingency charges associated with the Syntrix litigation matter and a lower sales mix of consumables, which have higher gross margins. Such impact was partially offset by higher margins on instrument and service sales. We believe our gross margin in future periods will depend on several factors, including: market conditions that may impact our pricing power; sales mix changes among consumable, instrument, and services; product mix changes between established products and new products in new markets; our cost structure for manufacturing operations; royalties; and our ability to create innovative and high premium products that meet or stimulate customer demand.

Income from operations increased by \$137.2 million in Q1 2014 compared to Q1 2013. Operating expenses in Q1 2013 included a \$105.9 million legal contingency charge associated primarily with the Syntrix patent litigation matter. ¶The lack of such expense in Q1 2014 and the increase in gross profit during the current quarter led to the increase in income from operations, despite the increases in research and development and selling, general and administrative expenses, which we expect to continue to grow.

Our effective tax rate was 28.4% in Q1 2014, as compared to 52.5% in Q1 2013. The variance from the U.S. federal statutory tax rate of 35% was primarily attributable to a higher mix of foreign earnings, such as earnings in Singapore and the United Kingdom, taxed at rates lower than the U.S. federal statutory tax rate, and tax deductions related to stock award activities which were recorded as discrete items in the quarter. Our future effective tax rate may vary ¶from the U.S. federal statutory tax rate due to the mix of earnings in tax jurisdictions with different statutory tax rates and the other factors discussed in the risk factor “We are subject to risks related to taxation in multiple jurisdictions” in Part I Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 29, 2013. We anticipate that our effective tax rate will trend lower than the U.S. federal statutory tax rate in the future due to the portion of our earnings that will be subject to lower statutory tax rates.

¶We ended Q1 2014 with cash, cash equivalents, and short-term investments totaling \$1.1 billion.

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Results of Operations

To enhance comparability, the following table sets forth our unaudited condensed consolidated statements of operations for the specified reporting periods stated as a percentage of total revenue.

	Q1 2014		Q1 2013	
Revenue:				
Product revenue	86.1	%	89.5	%
Service and other revenue	13.9		10.5	
Total revenue	100.0		100.0	
Cost of revenue:				
Cost of product revenue	26.5		27.2	
Cost of service and other revenue	5.1		4.5	
Amortization of acquired intangible assets	2.3		2.0	
Total cost of revenue	33.9		33.7	
Gross profit	66.1		66.3	
Operating expense:				
Research and development	18.3		18.6	
Selling, general and administrative	26.0		25.7	
Acquisition related (gain) expense, net	(0.2)	)	1.2	
Headquarter relocation	0.1		0.2	
Legal contingencies	—		32.0	
Unsolicited tender offer related expense	—		2.2	
Total operating expense	44.2		79.9	
Income (loss) from operations	21.9		(13.6))
Other income (expense):				
Interest income	0.2		0.6	
Interest expense	(2.3)	)	(2.9))
Cost-method investment related gain	—		1.8	
Other income (expense), net	0.1		(0.2))
Total other expense, net	(2.0)	)	(0.7))
Income (loss) before income taxes	19.9		(14.3))
Provision for (benefit from) income taxes	5.6		(7.5))
Net income (loss)	14.3	%	(6.8))%

Our fiscal year consists of 52 or 53 weeks ending the Sunday closest to December 31, with quarters of 13 or 14 weeks ending the Sunday closest to March 31, June 30, September 30, and December 31. The three month periods ended March 30, 2014 and March 31, 2013 were both 13 weeks.

Revenue

(Dollars in thousands)	Q1 2014	Q1 2013	Change	% Change
Product revenue	\$362,211	\$296,170	\$66,041	22 %
Service and other revenue	58,570	34,788	23,782	68
Total revenue	\$420,781	\$330,958	\$89,823	27 %

Product revenue consists primarily of revenue from the sale of consumables and instruments. Service and other revenue consists primarily of instrument service contract revenue as well as sequencing and genotyping service revenue. Revenues from businesses acquired in 2013 are predominantly service revenue.

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Consumables revenue increased \$37.6 million, or 18%, to \$242.5 million in Q1 2014 compared to \$204.9 million in Q1 2013. The increase was primarily attributable to sales of sequencing consumables, driven by higher utilization of our instruments and growth in the instrument installed base.

Instrument revenue increased \$27.7 million, or 31%, to \$115.8 million in Q1 2014 compared to \$88.1 million in Q1 2013, driven primarily by shipments of sequencing instruments, including new platforms introduced during the current quarter.

Service and other revenue increased \$23.8 million, or 68%, to \$58.6 million in Q1 2014 compared to \$34.8 million in Q1 2013. Revenues from businesses acquired in 2013 are predominantly service revenue. Excluding the impact of acquisitions completed in 2013, the increase in service and other revenue was 38%, which was driven by microarray service revenue as well as sequencing instrument service contract revenue as a result of our growing installed base.

Gross Margin

(Dollars in thousands)	Q1 2014	Q1 2013	Change	% Change
Gross profit	\$278,292	\$219,292	\$59,000	27 %
Gross margin	66.1 %	66.3 %		

Gross profit increased \$59 million, or 27%, to \$278.3 million in Q1 2014 in comparison to \$219.3 million in Q1 2013, primarily due to the increase in revenue. Excluding the gross profit from acquisitions completed in 2013, which was predominantly included in gross profit from service sales, the increase in gross profit was 26%. Gross margin decreased in Q1 2014 in comparison to Q1 2013 due to the negative impact from higher legal contingency charges and a lower sales mix of consumables, which have higher gross margins. Such impact was partially offset by higher margins on instruments and services sales during Q1 2014.

Operating Expense

(Dollars in thousands)	Q1 2014	Q1 2013	Change	% Change
Research and development	\$77,041	\$61,450		