

VERTEX PHARMACEUTICALS INC / MA  
Form 10-Q  
November 06, 2012

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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

**FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2012**

**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 000-19319**

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**VERTEX PHARMACEUTICALS INCORPORATED**

(Exact name of registrant as specified in its charter)

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

**04-3039129**  
(I.R.S. Employer Identification No.)

**130 WAVERLY STREET  
CAMBRIDGE, MASSACHUSETTS**  
(Address of principal executive offices)

**02139-4242**  
(Zip Code)

**(617) 341-6100**  
(Registrant's telephone number, including area code)

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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

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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 definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

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

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

<b>Common Stock, par value \$0.01 per share</b>	<b>216,827,066</b>
Class	Outstanding at October 26, 2012

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**VERTEX PHARMACEUTICALS INCORPORATED  
FORM 10-Q  
FOR THE QUARTER ENDED SEPTEMBER 30, 2012**

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"We," "us," "Vertex" and the "Company" as used in this Quarterly Report on Form 10-Q refer to Vertex Pharmaceuticals Incorporated, a Massachusetts corporation, and its subsidiaries.

"Vertex," "INCIVEK" and "KALYDECO" are registered trademarks of Vertex. Other brands, names and trademarks contained in this Quarterly Report on Form 10-Q, including "INCIVO" and "TELAVIC," are the property of their respective owners.

Table of Contents**Part I. Financial Information****Item 1. Financial Statements****Vertex Pharmaceuticals Incorporated****Condensed Consolidated Statements of Operations****(unaudited)****(in thousands, except per share amounts)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
<b>Revenues:</b>				
Product revenues, net	\$ 303,501	\$ 419,595	\$ 1,052,149	\$ 494,130
Royalty revenues	25,586	8,539	98,047	24,610
Collaborative revenues	6,919	231,066	42,852	328,546
<b>Total revenues</b>	<b>336,006</b>	<b>659,200</b>	<b>1,193,048</b>	<b>847,286</b>
<b>Costs and expenses:</b>				
Cost of product revenues (Note H)	30,680	35,285	161,147	40,689
Royalty expenses	7,856	3,121	31,023	9,689
Research and development expenses	200,161	189,052	593,076	521,268
Sales, general and administrative expenses	97,684	110,654	326,344	278,840
Restructuring expense (credit)	696	(419)	1,650	1,082
Intangible asset impairment charge		105,800		105,800
<b>Total costs and expenses</b>	<b>337,077</b>	<b>443,493</b>	<b>1,113,240</b>	<b>957,368</b>
Income (loss) from operations	(1,071)	215,707	79,808	(110,082)
Interest income	519	77	1,443	1,681
Interest expense	(4,560)	(7,059)	(12,860)	(26,022)
Change in fair value of derivative instruments		(8,115)		(15,933)
Income (loss) before provision for income taxes	(5,112)	200,610	68,391	(150,356)
Provision for (benefit from) income taxes	21,355	(27,842)	41,450	(3,394)
Net income (loss)	(26,467)	228,452	26,941	(146,962)
Net loss (income) attributable to noncontrolling interest (Alios)	(31,076)	(7,342)	(57,825)	17,907
Net income (loss) attributable to Vertex	\$ (57,543)	\$ 221,110	\$ (30,884)	\$ (129,055)
<b>Net income (loss) per share attributable to Vertex common shareholders:</b>				
Basic	\$ (0.27)	\$ 1.06	\$ (0.15)	\$ (0.63)
Diluted	\$ (0.27)	\$ 1.02	\$ (0.15)	\$ (0.63)

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Shares used in per share calculations:

Basic	213,767	206,002	211,053	204,262
Diluted	213,767	219,349	211,053	204,262

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

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**Vertex Pharmaceuticals Incorporated**

**Condensed Consolidated Statements of Comprehensive Income (Loss)**

(unaudited)

(in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Comprehensive income (loss)	\$ (26,210)	\$ 228,214	\$ 27,578	\$ (146,840)
Comprehensive loss (income) attributable to noncontrolling interest (Alios)	(31,076)	(7,342)	(57,825)	17,907
Comprehensive income (loss) attributable to Vertex	\$ (57,286)	\$ 220,872	\$ (30,247)	\$ (128,933)

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

Table of Contents**Vertex Pharmaceuticals Incorporated****Condensed Consolidated Balance Sheets****(unaudited)****(in thousands, except share and per share amounts)**

	<b>September 30, 2012(1)</b>	<b>December 31, 2011(1)</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 436,886	\$ 475,320
Marketable securities, available for sale	861,656	493,602
Restricted cash and cash equivalents (Alios)	74,954	51,878
Accounts receivable, net	139,629	183,135
Inventories	86,275	112,430
Prepaid expenses and other current assets	35,123	14,889
<b>Total current assets</b>	<b>1,634,523</b>	<b>1,331,254</b>
Restricted cash	32,166	34,090
Property and equipment, net	124,148	78,106
Fan Pier buildings	223,101	55,070
Intangible assets	663,500	663,500
Goodwill	30,992	30,992
Other assets	10,393	11,268
<b>Total assets</b>	<b>\$ 2,718,823</b>	<b>\$ 2,204,280</b>
<b>Liabilities and Shareholders' Equity</b>		
Current liabilities:		
Accounts payable	\$ 83,732	\$ 74,642
Accrued expenses	273,285	255,662
Deferred revenues, current portion	27,303	45,037
Accrued restructuring expense, current portion	4,596	4,932
Other liabilities, current portion	13,944	
Income taxes payable (Alios)	3,871	12,075
<b>Total current liabilities</b>	<b>406,731</b>	<b>392,348</b>
Deferred revenues, excluding current portion	103,626	118,095
Accrued restructuring expense, excluding current portion	19,559	21,381
Convertible senior subordinated notes (due 2015)	400,000	400,000
Deferred tax liability	279,466	243,707
Construction financing obligation	215,956	55,950
Other liabilities, excluding current portion	28,739	7,287
<b>Total liabilities</b>	<b>1,454,077</b>	<b>1,238,768</b>
Commitments and contingencies:		
Redeemable noncontrolling interest (Alios)	38,299	37,036
Shareholders' equity:		
Preferred stock, \$0.01 par value; 1,000,000 shares authorized; none issued and outstanding at September 30, 2012 and December 31, 2011		
Common stock, \$0.01 par value; 300,000,000 shares authorized; 216,341,505 and 209,303,995 shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively	2,141	2,072
Additional paid-in capital	4,471,727	4,200,659

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Accumulated other comprehensive loss	(416)	(1,053)
Accumulated deficit	(3,445,719)	(3,414,835)
<b>Total Vertex shareholders' equity</b>	<b>1,027,733</b>	<b>786,843</b>
Noncontrolling interest (Alios)	198,714	141,633
<b>Total shareholders' equity</b>	<b>1,226,447</b>	<b>928,476</b>
Total liabilities and shareholders' equity	\$ 2,718,823	\$ 2,204,280

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(1) Amounts include the assets and liabilities of Vertex's variable interest entity ("VIE"), Alios BioPharma, Inc. ("Alios"). Vertex's interests and obligations with respect to the VIE's assets and liabilities are limited to those accorded to Vertex in its agreement with Alios. See Note C, "Collaborative Arrangements," to these condensed consolidated financial statements for amounts.

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



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**Vertex Pharmaceuticals Incorporated**  
**Condensed Consolidated Statements of Shareholders' Equity and Noncontrolling Interest**  
**(unaudited)**  
**(in thousands)**

	Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive	Accumulated Deficit	Total Vertex Shareholders' Equity	Noncontrolling Interest (Alios)	Total Shareholders' Equity	Redeemable Noncontrolling Interest (Alios)
	Shares	Amount		(Loss)		Equity	(Alios)	Equity	(Alios)
Balance, December 31, 2010	203,523	\$ 2,016	\$ 3,947,433	\$ (1,067)	\$ (3,444,409)	\$ 503,973	\$	\$ 503,973	\$
Unrealized holding gains (losses) on marketable securities				(42)		(42)		(42)	
Foreign currency translation adjustment				164		164		164	
Net income (loss)					(129,055)	(129,055)	(17,907)	(146,962)	
Issuances of common stock:									
Benefit plans	4,938	49	115,199			115,248	(102)	115,146	
Stock-based compensation expense			89,474			89,474	528	90,002	
Alios noncontrolling interest upon consolidation							132,266	132,266	36,299
Change in liquidation value of redeemable noncontrolling interest							(397)	(397)	397
Balance, September 30, 2011	208,461	\$ 2,065	\$ 4,152,106	\$ (945)	\$ (3,573,464)	\$ 579,762	\$ 114,388	\$ 694,150	\$ 36,696

	Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive	Accumulated Deficit	Total Vertex Shareholders' Equity	Noncontrolling Interest (Alios)	Total Shareholders' Equity	Redeemable Noncontrolling Interest (Alios)
	Shares	Amount		(Loss)		Equity	(Alios)	Equity	(Alios)
Balance, December 31, 2011	209,304	\$ 2,072	\$ 4,200,659	\$ (1,053)	\$ (3,414,835)	\$ 786,843	\$ 141,633	\$ 928,476	\$ 37,036
Unrealized holding gains (losses) on marketable securities				324		324		324	
Foreign currency translation adjustment				313		313		313	
Net income (loss)					(30,884)	(30,884)	57,825	26,941	
Issuances of common stock:									
Benefit plans	7,038	69	182,803			182,872	150	183,022	
Stock-based compensation expense			87,168			87,168	369	87,537	
Tax benefit from equity compensation			1,097			1,097		1,097	
Change in liquidation value of redeemable noncontrolling interest							(1,263)	(1,263)	1,263
Balance, September 30, 2012	216,342	\$ 2,141	\$ 4,471,727	\$ (416)	\$ (3,445,719)	\$ 1,027,733	\$ 198,714	\$ 1,226,447	\$ 38,299

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

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## Vertex Pharmaceuticals Incorporated

## Condensed Consolidated Statements of Cash Flows

(unaudited)

(in thousands)

	Nine Months Ended September 30,	
	2012	2011
Cash flows from operating activities:		
Net income (loss)	\$ 26,941	\$ (146,962)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization expense	25,818	25,317
Stock-based compensation expense	86,649	89,172
Other non-cash based compensation expense	8,070	6,396
Intangible asset impairment charge		105,800
Secured notes (due 2012) discount amortization expense		11,856
Change in fair value of derivative instruments		15,933
Deferred income taxes	35,759	(18,244)
Loss on disposal of property and equipment	46	
Write-down of inventories to net realizable value	78,000	
Other non-cash items, net	(350)	14
Changes in operating assets and liabilities, excluding the effect of the acquisition of a variable interest entity (Alios):		
Accounts receivable, net	43,538	(433,132)
Inventories	(32,419)	(66,824)
Prepaid expenses and other current assets	(22,698)	(10,053)
Accounts payable	1,359	12,103
Accrued expenses and other liabilities	20,231	94,704
Excess tax benefit from share-based payment arrangements	(1,097)	
Accrued restructuring expense	(2,158)	(3,011)
Income taxes payable (Alios)	(8,204)	9,755
Deferred revenues	(32,203)	(52,752)
Net cash provided by (used in) operating activities	227,282	(359,928)
Cash flows from investing activities:		
Purchases of marketable securities	(1,309,044)	(251,089)
Sales and maturities of marketable securities	941,314	923,123
Payment for acquisition of a variable interest entity (Alios)		(60,000)
Expenditures for property and equipment	(43,094)	(25,266)
Decrease (increase) in restricted cash	1,923	(29)
Decrease (increase) in restricted cash and cash equivalents (Alios)	(23,075)	13,994
Increase in other assets	(997)	(545)
Net cash provided by (used in) investing activities	(432,973)	600,188
Cash flows from financing activities:		
Excess tax benefit from share-based payment arrangements	1,097	
Issuances of common stock from employee benefit plans	174,950	108,742
Payments on capital lease obligation	(2,408)	
Payments on facility lease obligation	(6,272)	
Payments to redeem a portion of secured notes (due 2012)		(50,000)
Net cash provided by financing activities	167,367	58,742
Effect of changes in exchange rates on cash	(110)	346
Net increase (decrease) in cash and cash equivalents	(38,434)	299,348
Cash and cash equivalents beginning of period	475,320	243,197
Cash and cash equivalents end of period	\$ 436,886	\$ 542,545

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Supplemental disclosure of cash flow information:

Cash paid for interest	\$ 6,700	\$ 6,812
Capitalization of Fan Pier buildings related to financing lease transactions	\$ 167,996	\$ 24,179
Assets acquired under capital lease	\$ 27,552	\$

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

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**Vertex Pharmaceuticals Incorporated**

**Notes to Condensed Consolidated Financial Statements**

**(unaudited)**

**A. Basis of Presentation and Accounting Policies**

*Basis of Presentation*

The accompanying condensed consolidated financial statements are unaudited and have been prepared by Vertex Pharmaceuticals Incorporated ("Vertex" or the "Company") in accordance with accounting principles generally accepted in the United States of America ("GAAP").

The condensed consolidated financial statements reflect the operations of (i) the Company, (ii) its wholly-owned subsidiaries and (iii) Alios BioPharma, Inc. ("Alios"), a collaborator that is a variable interest entity (a "VIE") for which the Company is deemed under applicable accounting guidance to be the primary beneficiary. All material intercompany balances and transactions have been eliminated. The Company operates in one segment, pharmaceuticals.

Certain information and footnote disclosures normally included in the Company's annual financial statements have been condensed or omitted. These interim financial statements, in the opinion of management, reflect all normal recurring adjustments (including accruals) necessary for a fair presentation of the financial position and results of operations for the interim periods ended September 30, 2012 and 2011.

The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the full fiscal year. These interim financial statements should be read in conjunction with the audited financial statements for the year ended December 31, 2011, which are contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2011 that was filed with the Securities and Exchange Commission (the "SEC") on February 22, 2012 (the "2011 Annual Report on Form 10-K").

*Use of Estimates and Summary of Significant Accounting Policies*

The preparation of condensed consolidated financial statements in accordance with GAAP requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements, and the amounts of revenues and expenses during the reported periods. Significant estimates in these condensed consolidated financial statements have been made in connection with the calculation of revenues, inventories, research and development expenses, stock-based compensation expense, restructuring expense, the fair value of intangible assets, noncontrolling interest (Alios), income tax provision, derivative instruments and debt securities. The Company bases its estimates on historical experience and various other assumptions, including in certain circumstances future projections, that management believes to be reasonable under the circumstances. Actual results could differ from those estimates. Changes in estimates are reflected in reported results in the period in which they become known.

The Company's significant accounting policies are described in Note A, "Nature of Business and Accounting Policies," in the 2011 Annual Report on Form 10-K.

*Recent Accounting Pronouncements*

For a discussion of recent accounting pronouncements please refer to Note A, "Nature of Business and Accounting Policies Recent Accounting Pronouncements," in the 2011 Annual Report on

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**Vertex Pharmaceuticals Incorporated**

**Notes to Condensed Consolidated Financial Statements (Continued)**

(unaudited)

**A. Basis of Presentation and Accounting Policies (Continued)**

Form 10-K, as supplemented below. The Company did not adopt any new accounting pronouncements during the nine months ended September 30, 2012 that had a material effect on the Company's condensed consolidated financial statements.

In the first quarter of 2012, the Company retrospectively adopted amended guidance issued in June 2011 by the Financial Accounting Standards Board ("FASB") that resulted in two separate, but consecutive, statements of operations and comprehensive income (loss) that affected the presentation of the Company's condensed consolidated financial statements.

In July 2012, the FASB issued amended guidance applicable to annual impairment tests of indefinite-lived intangible assets. The FASB added an optional qualitative assessment for determining whether an indefinite-lived intangible asset is impaired. Prior to this guidance, companies were required to perform an annual impairment test that included a calculation of the fair value of the asset and a comparison of that fair value with its carrying value. If the carrying value exceeded the fair value, an impairment was recorded. The amended guidance allows a company the option to perform a qualitative assessment, considering both negative and positive evidence, regarding the potential impairment of the indefinite-lived intangible asset. If, based on the qualitative analysis, a company determines that it is more likely than not that the fair value of such an asset exceeds its carrying value, the company would be permitted to conclude that the indefinite-lived intangible asset was not impaired without a quantitative calculation of the fair value of the asset. Otherwise, the company would perform the quantitative calculation of the fair value and the comparison with the carrying value. This amended guidance will be effective for annual impairment tests performed by the Company for fiscal years beginning on January 1, 2013 and early adoption is permitted.

**B. Product Revenues, Net**

The Company sells its products principally to a limited number of major wholesalers, as well as selected regional wholesalers and specialty pharmacy providers (collectively, its "Distributors"), that subsequently resell the products to patients and health care providers. The Company recognizes net revenues from product sales upon delivery as long as (i) there is persuasive evidence that an arrangement exists between the Company and the Distributor, (ii) collectibility is reasonably assured and (iii) the price is fixed or determinable.

The Company has written contracts with its Distributors and delivery occurs when a shipment of a product is received. The Company evaluates the creditworthiness of each of its Distributors to determine whether revenues can be recognized upon delivery, subject to satisfaction of the other requirements, or whether recognition is required to be delayed until receipt of payment. In order to conclude that the price is fixed or determinable, the Company must be able to (i) calculate its gross product revenues from sales to Distributors and (ii) reasonably estimate its net product revenues. The Company calculates gross product revenues based on the wholesale acquisition cost that the Company charges its Distributors. The Company estimates its net product revenues by deducting from its gross product revenues (a) trade allowances, such as invoice discounts for prompt payment and distributor fees, (b) estimated government and private payor rebates, chargebacks and discounts, such as Medicaid reimbursements, (c) reserves for expected product returns and (d) estimated costs of incentives offered to certain indirect customers, including patients.

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**Vertex Pharmaceuticals Incorporated**

**Notes to Condensed Consolidated Financial Statements (Continued)**

(unaudited)

**B. Product Revenues, Net (Continued)**

*Trade Allowances:* The Company generally provides invoice discounts on product sales to its Distributors for prompt payment and pays fees for distribution services, such as fees for certain data that Distributors provide to the Company. The payment terms for sales to Distributors generally include a 2% discount for payment within 30 days. The Company expects that, based on its experience, its Distributors will earn these discounts and fees, and deducts the full amount of these discounts and fees from its gross product revenues and accounts receivable at the time such revenues are recognized.

*Rebates, Chargebacks and Discounts:* The Company contracts with Medicaid, other government agencies and various private organizations (collectively, its "Third-party Payors") so that products will be eligible for purchase by, or partial or full reimbursement from, such Third-party Payors. The Company estimates the rebates, chargebacks and discounts it will provide to Third-party Payors and deducts these estimated amounts from its gross product revenues at the time the revenues are recognized. For each product, the Company estimates the aggregate rebates, chargebacks and discounts that it will provide to Third-party Payors based upon (i) the Company's contracts with these Third-party Payors, (ii) the government-mandated discounts applicable to government-funded programs and (iii) information obtained from the Company's Distributors and other third parties regarding the payor mix for such product.

*Product Returns:* The Company estimates the amount of each product that will be returned and deducts these estimated amounts from its gross revenues at the time the revenues are recognized. The Company's Distributors have the right to return unopened unexpired packages beginning six months prior to the labeled expiration date and ending twelve months after the labeled expiration date. To date product returns have been minimal, and based on the inventory levels held by its Distributors and its distribution model, the Company believes that returns of its products will continue to be minimal.

*Other Incentives:* Other incentives that the Company offers to indirect customers include co-pay mitigation rebates provided by the Company to commercially insured patients who have coverage and who reside in states that permit co-pay mitigation programs. The Company's co-pay mitigation program is intended to reduce each participating patient's portion of the financial responsibility for a product's purchase price to a specified dollar amount. Based upon the terms of the Company's co-pay mitigation programs, the Company estimates average co-pay mitigation amounts for each of its products in order to establish its accruals for co-pay mitigation rebates and deducts these estimated amounts from its gross product revenues at the later of the date (i) the revenues are recognized or (ii) the incentive is offered. The Company's co-pay mitigation rebates are subject to expiration.

Table of Contents**Vertex Pharmaceuticals Incorporated****Notes to Condensed Consolidated Financial Statements (Continued)**

(unaudited)

**B. Product Revenues, Net (Continued)**

The following table summarizes activity in each of the product revenue allowance and reserve categories during the nine months ended September 30, 2012:

	Trade Allowances	Rebates, Chargebacks and Discounts	Product Returns	Other Incentives	Total
	(in thousands)				
<b>Balance at December 31, 2011</b>	\$ 11,162	\$ 52,659	\$ 340	\$ 5,202	\$ 69,363
Provision related to current period sales	44,433	159,502	579	15,340	219,854
Adjustments related to prior period sales		2,760		72	2,832
Credits/payments made	(50,914)	(150,404)	(484)	(16,916)	(218,718)
<b>Balance at September 30, 2012</b>	\$ 4,681	\$ 64,517	\$ 435	\$ 3,698	\$ 73,331

**C. Collaborative Arrangements***Janssen Pharmaceutica, N.V.*

In 2006, the Company entered into a collaboration agreement with Janssen Pharmaceutica, N.V. ("Janssen") for the development, manufacture and commercialization of telaprevir, which Janssen began marketing under the brand name INCIVO in certain of its territories in September 2011. Under the collaboration agreement, Janssen agreed to be responsible for 50% of the drug development costs incurred under the development program for the parties' territories (North America for the Company, and the rest of the world, other than certain countries in Asia, for Janssen) and has exclusive rights to commercialize telaprevir in its territories including Europe, South America, the Middle East, Africa and Australia.

Janssen pays the Company a tiered royalty averaging in the mid-20% range as a percentage of net sales of INCIVO in Janssen's territories. Janssen is required under the agreement to use diligent efforts to maximize net sales of INCIVO in its territories through its commercial marketing, pricing and contracting strategies. In addition, Janssen is responsible for certain third-party royalties on net sales of INCIVO in its territories.

Janssen made a \$165.0 million up-front license payment to the Company in 2006. The up-front license payment is being amortized over the Company's estimated period of performance under the collaboration agreement. As of September 30, 2012, there were \$46.6 million in deferred revenues related to this up-front license payment that the Company expects to recognize over the remaining estimated period of performance.

Under the collaboration agreement, Janssen agreed to make contingent milestone payments for successful development, approval and launch of telaprevir as a product in its territories. At the inception of the agreement, the Company determined that all of these contingent milestones were substantive and would result in revenues in the period in which the milestone was achieved. The Company has earned \$350.0 million of these contingent milestone payments, including a \$50.0 million milestone payment earned in the first quarter of 2011 in connection with the European Medicines Agency's acceptance of the marketing authorization application for INCIVO and an aggregate of \$200.0 million in milestone payments earned in the third quarter of 2011 related to the approval of

Table of Contents**Vertex Pharmaceuticals Incorporated****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)****C. Collaborative Arrangements (Continued)**

INCIVO by the European Commission and the launch of INCIVO in the European Union. The Company does not expect to receive any further milestone payments under this agreement.

Under the Janssen collaboration agreement, each party incurs internal and external reimbursable expenses related to the telaprevir development program and is reimbursed by the other party for 50% of these expenses. The Company recognizes the full amount of the reimbursable costs it incurs as research and development expenses on its condensed consolidated statements of operations. The Company recognizes the amounts that Janssen is obligated to pay the Company with respect to reimbursable expenses, net of reimbursable expenses incurred by Janssen, as collaborative revenues. In the three and nine months ended September 30, 2012 and 2011, Janssen incurred more reimbursable costs than the Company, and the net amounts payable by the Company to reimburse Janssen were recorded as a reduction of collaborative revenues.

Each of the parties is responsible for drug supply in its territories. In the three and nine months ended September 30, 2011 and the three months ended March 31, 2012, the Company provided Janssen certain services through the Company's third-party manufacturing network for telaprevir. Reimbursements from Janssen for these manufacturing services were recorded as collaborative revenues.

Janssen may terminate the collaboration agreement upon the later of (i) one year's advance notice and (ii) such period as may be required to assign and transfer to the Company specified filings and approvals. The agreement also may be terminated by either party for a material breach by the other, subject to notice and cure provisions. Unless earlier terminated, the agreement will continue in effect until the expiration of Janssen's royalty obligations, which expire on a country-by-country basis with the last-to-expire patent covering telaprevir. In the European Union, the Company has a patent covering the composition-of-matter of telaprevir that expires in 2021 and expects to obtain extensions to the term of this patent through 2026.

During the three and nine months ended September 30, 2012 and 2011, the Company recognized the following revenues attributable to the Janssen collaboration:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in thousands)			
Royalty revenues	\$ 19,957	\$ 1,276	\$ 80,811	\$ 3,825
Collaborative revenues:				
Amortized portion of up-front payment	\$ 3,107	\$ 3,107	\$ 9,321	\$ 9,321
Milestone revenues		200,000		250,000
Net payment for telaprevir development costs	(503)	(2,557)	(2,569)	(6,810)
Reimbursement for manufacturing services		7,170	4,449	20,383
<b>Total collaborative revenues attributable to the Janssen collaboration</b>	<b>\$ 2,604</b>	<b>\$ 207,720</b>	<b>\$ 11,201</b>	<b>\$ 272,894</b>
<b>Total revenues attributable to the Janssen collaboration</b>	<b>\$ 22,561</b>	<b>\$ 208,996</b>	<b>\$ 92,012</b>	<b>\$ 276,719</b>



Table of Contents**Vertex Pharmaceuticals Incorporated****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)****C. Collaborative Arrangements (Continued)***Mitsubishi Tanabe Pharma Corporation*

The Company has a collaboration agreement (the "MTPC Agreement") with Mitsubishi Tanabe Pharma Corporation ("Mitsubishi Tanabe") pursuant to which Mitsubishi Tanabe has a fully-paid license to manufacture and commercialize TELAVIC (the brand name under which Mitsubishi Tanabe is marketing telaprevir) in Japan and other specified countries in Asia. In September 2011, Mitsubishi Tanabe obtained approval to market TELAVIC in Japan.

The parties entered into the MTPC Agreement in 2004 and amended it in 2009. Pursuant to the MTPC Agreement, Mitsubishi Tanabe provided financial and other support for the development and commercialization of telaprevir, made a \$105.0 million payment in connection with the 2009 amendment of the collaboration agreement and made a \$65.0 million commercial milestone payment in the fourth quarter of 2011 related to the commercialization of TELAVIC in Japan. There are no further milestone payments under this collaboration agreement. Mitsubishi Tanabe is responsible for its own development and manufacturing costs in its territory.

Mitsubishi Tanabe may terminate the MTPC Agreement at any time without cause upon 60 days' prior written notice to the Company. The MTPC Agreement also may be terminated by either party for a material breach by the other, subject to notice and cure provisions. Unless earlier terminated, the MTPC Agreement will continue in effect until the expiration of the last-to-expire patent covering telaprevir in Mitsubishi Tanabe's territories. In Japan, the Company has a patent covering the composition-of-matter of telaprevir that expires in 2021.

The \$105.0 million payment that the Company received in the third quarter of 2009 in connection with the amendment is a nonrefundable, up-front license fee, and revenues related to the 2009 payment were recognized on a straight-line basis over the period of performance of the Company's obligations under the amended agreement. The final \$3.2 million in deferred revenues related to the 2009 up-front license payment was recognized in April 2012. In connection with the amendment to the MTPC Agreement, the Company supplied manufacturing services to Mitsubishi Tanabe, until April 2012, through the Company's third-party manufacturing network for telaprevir.

During the three and nine months ended September 30, 2012 and 2011, the Company recognized the following collaborative revenues attributable to the Mitsubishi Tanabe collaboration:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
	<b>(in thousands)</b>			
Amortized portion of up-front payments	\$	\$ 9,558	\$ 12,744	\$ 28,674
Milestone revenues		1,758	485	3,152
Payments for manufacturing services		8,184	5,650	14,032
Total collaborative revenues attributable to the Mitsubishi Tanabe collaboration	\$	\$ 19,500	\$ 18,879	\$ 45,858

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**Vertex Pharmaceuticals Incorporated**

**Notes to Condensed Consolidated Financial Statements (Continued)**

(unaudited)

**C. Collaborative Arrangements (Continued)**

*Cystic Fibrosis Foundation Therapeutics Incorporated*

In April 2011, the Company entered into an amendment (the "April 2011 Amendment") to its existing collaboration agreement with Cystic Fibrosis Foundation Therapeutics Incorporated ("CFFT") pursuant to which CFFT agreed to provide financial support for (i) development activities for VX-661, a corrector compound discovered under the collaboration, and (ii) additional research and development activities directed at discovering new corrector compounds.

The Company entered into the original collaboration agreement with CFFT in 2004 and amended it several times to, among other things, provide partial funding for its cystic fibrosis drug discovery and development efforts. In 2006, the Company received a \$1.5 million milestone payment from CFFT. There are no additional milestones payable by CFFT to the Company pursuant to the collaboration agreement, as amended. Under the April 2011 Amendment, CFFT agreed to provide the Company with up to \$75.0 million in funding over approximately five years for corrector-compound research and development activities. The Company retains the right to develop and commercialize KALYDECO (ivacaftor), VX-809, VX-661 and any other compounds discovered during the course of the research collaboration with CFFT. The Company recognized collaborative revenues from this collaboration of \$4.3 million and \$12.8 million, respectively, during the three and nine months ended September 30, 2012, and \$3.8 million and \$9.8 million during the three and nine months ended September 30, 2011, respectively.

In the original agreement, as amended prior to the April 2011 Amendment, the Company agreed to pay CFFT tiered royalties calculated as a percentage, ranging from single digits to sub-teens, of annual net sales of any approved drugs discovered during the research term that ended in 2008, including KALYDECO, VX-809 and VX-661. The April 2011 Amendment provides for a tiered royalty in the same range on net sales of corrector compounds discovered during the research term that began in 2011. In the third quarter of 2012, CFFT earned a commercial milestone payment from the Company upon achievement of certain sales levels for KALYDECO, which was reflected in the Company's cost of product revenues for the three and nine months ended September 30, 2012. The Company is obligated to make one additional commercial milestone payment upon achievement of certain sales levels of KALYDECO and two one-time commercial milestone payments upon achievement of certain sales levels for a corrector compound such as VX-809 or VX-661. The Company began marketing KALYDECO in the United States in the first quarter of 2012 and began marketing KALYDECO in certain countries in the European Union in the third quarter of 2012.

The Company has royalty obligations to CFFT for each compound commercialized pursuant to this collaboration until the expiration of patents covering that compound. The Company has patents in the United States and European Union covering the composition-of-matter of ivacaftor that expire in 2027 and 2025, respectively, subject to potential patent life extensions. CFFT may terminate its funding obligations under the collaboration, as amended, in certain circumstances, in which case there will be a proportional adjustment to the royalty rates and commercial milestone payments for certain corrector compounds. The collaboration also may be terminated by either party for a material breach by the other, subject to notice and cure provisions.

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**Vertex Pharmaceuticals Incorporated**

**Notes to Condensed Consolidated Financial Statements (Continued)**

(unaudited)

**C. Collaborative Arrangements (Continued)**

*Alios BioPharma, Inc.*

License and Collaboration Agreement

On June 13, 2011, the Company entered into a license and collaboration agreement (the "Alios Agreement") with Alios, a privately-held biotechnology company. The Company and Alios are collaborating on the research, development and commercialization of an HCV nucleotide analogue discovered by Alios, VX-135 (formerly referred to as ALS-2200), which is designed to act on the HCV polymerase. In the third quarter of 2012, the Company ended the development of ALS-2158, a second HCV nucleotide analogue discovered by Alios and licensed to the Company pursuant to the Alios Agreement, because a Phase 1 clinical trial demonstrated that there was insufficient antiviral activity to warrant proceeding with further clinical development of that molecule.

Alios and the Company began clinical development of VX-135 and ALS-2158 in December 2011. The Company is responsible for all costs related to development, commercialization and manufacturing of the compounds pursuant to the Alios Agreement, provided funding to Alios to conduct the Phase 1 clinical trials for VX-135 and ALS-2158 and is providing funding for a research program directed to the discovery of additional HCV nucleotide analogues that act on the HCV polymerase.

Under the terms of the Alios Agreement, the Company received exclusive worldwide rights to VX-135 and ALS-2158, and has the option to select additional compounds discovered in the research program. The Company paid Alios a \$60.0 million up-front payment. As of September 30, 2012, Alios had earned an aggregate of \$60.0 million in development milestone payments pursuant to the Alios Agreement, including a \$25.0 million milestone payment that the Company paid to Alios in the third quarter of 2012. The Alios Agreement provides for development milestone payments to Alios of up to an additional \$312.5 million if VX-135 is approved and commercialized. The Alios Agreement provides for additional development milestone payments to Alios if a second HCV nucleotide analogue is approved and commercialized. Alios also is eligible to receive commercial milestone payments of up to \$750.0 million, as well as tiered royalties on net sales of approved drugs.

The Company may terminate the Alios Agreement (i) upon 30 days' notice to Alios if the Company ceases development after VX-135 has experienced a technical failure and/or (ii) upon 60 days' notice to Alios at any time after the Company completes specified Phase 2a clinical trials. The Alios Agreement also may be terminated by either party for a material breach by the other, and by Alios for the Company's inactivity or if the Company challenges certain Alios patents, in each case subject to notice and cure provisions. Unless earlier terminated, the Alios Agreement will continue in effect until the expiration of the Company's royalty obligations, which expire on a country-by-country basis on the later of (a) the date the last-to-expire patent covering a licensed product expires or (b) ten years after the first commercial sale in the country.

Alios is continuing to operate as a separate entity, is engaged in other programs directed at developing novel drugs that are not covered by the Alios Agreement and maintains ownership of the underlying patent rights that are licensed to the Company pursuant to the Alios Agreement. Under applicable accounting guidance, the Company has determined that Alios is a VIE, that Alios is a business and that the Company is Alios' primary beneficiary. The Company based these determinations on, among other factors, the significance to Alios of the licensed compounds and on the Company's

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**Vertex Pharmaceuticals Incorporated**

**Notes to Condensed Consolidated Financial Statements (Continued)**

(unaudited)

**C. Collaborative Arrangements (Continued)**

power, through the joint steering committee for the licensed compounds established under the Alios Agreement, to direct the activities that most significantly affect the economic performance of Alios.

Accordingly, the Company consolidated Alios' statements of operations and financial condition with the Company's consolidated financial statements beginning on June 13, 2011. However, the Company's interests in Alios are limited to those accorded to the Company in the Alios Agreement. In particular, the Company did not acquire any equity interest in Alios, any interest in Alios' cash and cash equivalents or any control over Alios' activities that do not relate to the Alios Agreement. Alios does not have any right to the Company's assets except as provided in the Alios Agreement.

The initial consolidation of a VIE that is determined to be a business is accounted for as a business combination. As a result, as of June 13, 2011 the Company recorded all of Alios' assets and liabilities at fair value on the Company's condensed consolidated balance sheet. The Company continues to consolidate Alios' financial statements by (A) eliminating all intercompany balances and transactions and (B) allocating the noncontrolling interest in Alios between redeemable noncontrolling interest (Alios) and noncontrolling interest (Alios) on the Company's condensed consolidated balance sheet and reflecting net loss (income) attributable to noncontrolling interest (Alios) in the Company's condensed consolidated statement of operations.

Intangible Assets and Goodwill

As of September 30, 2012 and December 31, 2011, the Company had \$250.6 million of intangible assets and \$4.9 million of goodwill related to Alios. The Company tests Alios' intangible assets and goodwill for impairment on an annual basis as of October 1, and more frequently if indicators are present or changes in circumstance suggest that impairment may exist. In connection with each annual impairment assessment and any interim impairment assessment, the Company compares the fair value of the asset as of the date of the assessment with the carrying value of the asset on the Company's condensed consolidated balance sheet. In the third quarter of 2012, after the Company ended the development of ALS-2158, the Company evaluated the Alios HCV nucleotide analogue program for impairment. The Company determined that there was no impairment to the program in the third quarter of 2012 because of the advancement of VX-135. No impairment has been found with respect to these intangible assets or goodwill since the effective date of the collaboration.

Noncontrolling Interest (Alios)

The Company records noncontrolling interest (Alios) on two lines on its condensed consolidated balance sheets. The noncontrolling interest (Alios) is reflected on two separate lines because Alios has both common shareholders and preferred shareholders that are entitled to redemption rights in certain circumstances. The Company records net loss (income) attributable to noncontrolling interest (Alios) on its condensed consolidated statements of operations, reflecting Alios' net loss (income) for the reporting period, adjusted for changes in the fair value of contingent milestone and royalty payments, which are evaluated each reporting period. A summary of net loss (income) attributable to

Table of Contents**Vertex Pharmaceuticals Incorporated****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)****C. Collaborative Arrangements (Continued)**

noncontrolling interest (Alios) for the three and nine months ended September 30, 2012 and 2011 is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in thousands)			
Loss (income) before provision for income taxes	\$ 5,090	\$ 5,258	\$ 14,581	\$ 6,059
Decrease (increase) in fair value of contingent milestone and royalty payments	(57,560)	(17,450)	(112,760)	(17,450)
Provision for income taxes	21,394	4,850	40,354	29,298
Net loss (income) attributable to noncontrolling interest (Alios)	\$ (31,076)	\$ (7,342)	\$ (57,825)	\$ 17,907

The Company uses present-value models to determine the estimated fair value of the contingent milestone and royalty payments, based on assumptions regarding the probability of achieving the relevant milestones, estimates regarding the time to develop the Alios HCV nucleotide analogues, estimates of future cash flows from potential product sales and assumptions regarding the appropriate discount rates. In the three and nine months ended September 30, 2012, the fair value of the contingent milestone and royalty payments increased by \$57.6 million and \$112.8 million, respectively, as a result of the continued advancement of VX-135 in clinical trials. In the three and nine months ended September 30, 2011, the fair value of contingent milestone and royalty payments increased by \$17.5 million due to the advancement of VX-135 and ALS-2158 during the third quarter of 2011. If VX-135 continues to advance in clinical development, the Company expects it will record additional increases in the fair value of the contingent milestone and royalty payments in future periods. Any such increases will affect net income (loss) attributable to Vertex and any such effect may be material.

Table of Contents**Vertex Pharmaceuticals Incorporated****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)****C. Collaborative Arrangements (Continued)**Alios Balance Sheet Information

The following table summarizes items related to Alios included in the Company's condensed consolidated balance sheets as of September 30, 2012 and December 31, 2011:

	As of September 30, 2012	As of December 31, 2011
	(in thousands)	
Restricted cash and cash equivalents (Alios)	\$ 74,954	\$ 51,878
Prepaid expenses and other current assets	1,642	2,299
Property and equipment, net	1,754	1,925
Intangible assets	250,600	250,600
Goodwill	4,890	4,890
Other assets	153	133
Accounts payable	1,616	4,132
Accrued expenses	4,983	4,304
Income taxes payable (Alios)	3,871	12,075
Deferred tax liability	151,880	116,121
Other liabilities, excluding current portion	1,174	1,030
Redeemable noncontrolling interest (Alios)	38,299	37,036
Noncontrolling interest (Alios)	198,714	141,633

The Company has recorded Alios' cash and cash equivalents as restricted cash and cash equivalents (Alios) because (i) the Company does not have any interest in or control over Alios' cash and cash equivalents and (ii) the Alios Agreement does not provide for these assets to be used for the development of the assets that the Company licensed from Alios pursuant to the collaboration. Assets recorded as a result of consolidating Alios' financial condition into the Company's condensed consolidated balance sheets do not represent additional assets that could be used to satisfy claims against the Company's general assets.

*Research and Development Funding*

The Company's collaborators funded portions of the Company's research and development programs related to specific drugs, drug candidates and research targets, including telaprevir, VX-661 and research directed toward identifying additional corrector compounds for the treatment of cystic fibrosis. The Company's collaborative revenues, including amortization of up-front license fees and milestone revenues, were \$6.9 million and \$231.1 million in the three months ended September 30, 2012 and 2011, respectively, and \$42.9 million and \$328.5 million in the nine months ended September 30, 2012 and 2011, respectively. The Company's research and development expenses allocated to programs in which a collaborator funded at least a portion of the research and development expenses were approximately \$32 million and \$45 million in the three months ended September 30, 2012 and 2011, respectively, and approximately \$99 million and \$110 million in the nine months ended September 30, 2012 and 2011, respectively.

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**Vertex Pharmaceuticals Incorporated**

**Notes to Condensed Consolidated Financial Statements (Continued)**

(unaudited)

**D. Acquisition of ViroChem Pharma Inc.**

On March 12, 2009, the Company acquired 100% of the outstanding equity of ViroChem Pharma Inc. ("ViroChem"), a privately-held biotechnology company based in Canada. As of September 30, 2012 and December 31, 2011, the Company reflected on its condensed consolidated balance sheets \$412.9 million of intangible assets related to VX-222, a non-nucleoside HCV polymerase inhibitor that it added to its HCV drug development portfolio when the Company acquired ViroChem. The Company's condensed consolidated balance sheets as of September 30, 2012 and December 31, 2011 also reflected goodwill of \$26.1 million resulting from the ViroChem acquisition. Goodwill and VX-222 are tested for impairment on an annual basis as of October 1, and more frequently if indicators are present or changes in circumstance suggest that impairment may exist. No impairment has been found with respect to goodwill or VX-222 since the acquisition date.

In the third quarter of 2011, the Company recorded an impairment charge of \$105.8 million related to VX-759, a second HCV polymerase inhibitor that had been discovered by ViroChem. In connection with this impairment charge, the Company recorded a benefit from income taxes of \$32.7 million in the third quarter of 2011. The fair value of VX-759 following the impairment charge was zero.

A deferred tax liability related to ViroChem of \$127.6 million recorded as of September 30, 2012 and December 31, 2011 primarily relates to the tax effect of future amortization or impairments associated with VX-222, which are not deductible for tax purposes.

**E. Earnings Per Share**

Basic and diluted net income per share attributable to Vertex common shareholders are presented in conformity with the two-class method required for participating securities. Under the two-class method, earnings are allocated to (i) Vertex common shares, excluding shares of restricted stock that have been issued but have not yet vested, and (ii) participating securities, based on their respective weighted-average shares outstanding for the period. Shares of unvested restricted stock have the non-forfeitable right to receive dividends on an equal basis with other outstanding common stock. As a result, these unvested shares of restricted stock are considered participating securities that must be included in the calculation of basic and diluted net income per share attributable to Vertex common shareholders using the two-class method. Potentially dilutive shares result from the assumed exercise of outstanding stock options (the proceeds of which are then assumed to have been used to repurchase outstanding stock using the treasury stock method) and the assumed conversion of convertible notes.

Basic net loss per share attributable to Vertex common shareholders is based upon the weighted-average number of common shares outstanding during the period, excluding restricted stock that has been issued but is not yet vested. Diluted net loss per share attributable to Vertex common shareholders is based upon the weighted-average number of common shares outstanding during the period plus additional weighted-average common equivalent shares outstanding during the period when the effect is dilutive.

Table of Contents**Vertex Pharmaceuticals Incorporated****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)****E. Earnings Per Share (Continued)**

The following table sets forth the computation of basic and diluted net income (loss) per share for the three and nine months ended September 30, 2012 and 2011:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in thousands, except per share amounts)			
<i>Basic net income (loss) attributable to Vertex per common share calculation:</i>				
Net income (loss) attributable to Vertex common shareholders	\$ (57,543)	\$ 221,110	\$ (30,884)	\$ (129,055)
Less: Undistributed earnings allocated to participating securities		(2,136)		
Net income (loss) attributable to Vertex common shareholders basic	\$ (57,543)	\$ 218,974	\$ (30,884)	\$ (129,055)
Basic weighted-average common shares outstanding	213,767	206,002	211,053	204,262
Basic net income (loss) attributable to Vertex per common share	\$ (0.27)	\$ 1.06	\$ (0.15)	\$ (0.63)
<i>Diluted net income (loss) attributable to Vertex per common share calculation:</i>				
Net income (loss) attributable to Vertex common shareholders	\$ (57,543)	\$ 221,110	\$ (30,884)	\$ (129,055)
Less: Undistributed earnings allocated to participating securities		(2,007)		
Plus: Interest expense related to convertible senior subordinated notes		3,742		
Net income (loss) attributable to Vertex common shareholders diluted	\$ (57,543)	\$ 222,845	\$ (30,884)	\$ (129,055)
Weighted-average shares used to compute basic net income (loss) per common share	213,767	206,002	211,053	204,262
Effect of potentially dilutive securities:				
Convertible senior subordinated notes		8,889		
Stock options		4,398		
Other		60		
Weighted-average shares used to compute diluted net income (loss) per common share	213,767	219,349	211,053	204,262
Diluted net income (loss) attributable to Vertex per common share	\$ (0.27)	\$ 1.02	\$ (0.15)	\$ (0.63)



Table of Contents**Vertex Pharmaceuticals Incorporated****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)****E. Earnings Per Share (Continued)**

The Company did not include the securities described in the following table in the computation of the net income (loss) attributable to Vertex per common share calculations because the effect would have been anti-dilutive during each such period:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in thousands)			
Stock options	20,226	7,267	20,226	21,391
Convertible senior subordinated notes	8,192		8,192	8,192
Unvested restricted stock and restricted stock units	2,222	13	2,222	2,020

**F. Fair Value of Financial Instruments**

The fair value of the Company's financial assets and liabilities reflects the Company's estimate of amounts that it would have received in connection with the sale of the assets or paid in connection with the transfer of the liabilities in an orderly transaction between market participants at the measurement date. In connection with measuring the fair value of its assets and liabilities, the Company seeks to maximize the use of observable inputs (market data obtained from sources independent from the Company) and to minimize the use of unobservable inputs (the Company's assumptions about how market participants would price assets and liabilities). The following fair value hierarchy is used to classify assets and liabilities based on the observable inputs and unobservable inputs used in order to value the assets and liabilities:

- Level 1: Quoted prices in active markets for identical assets or liabilities. An active market for an asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis.
- Level 2: Observable inputs other than Level 1 inputs. Examples of Level 2 inputs include quoted prices in active markets for similar assets or liabilities and quoted prices for identical assets or liabilities in markets that are not active.
- Level 3: Unobservable inputs based on the Company's assessment of the assumptions that market participants would use in pricing the asset or liability.

The Company's investment strategy is focused on capital preservation. The Company invests in instruments that meet the credit quality standards outlined in the Company's investment policy. This policy also limits the amount of credit exposure to any one issue or type of instrument. As of September 30, 2012, the Company's investments were in a money market fund, short-term U.S. Treasury securities, short-term government-sponsored enterprise securities, corporate debt securities and commercial paper.

As of September 30, 2012, all of the Company's financial assets that were subject to fair value measurements were valued using observable inputs. The Company's financial assets valued based on Level 1 inputs consisted of a money market fund, U.S. Treasury securities and government-sponsored

Table of Contents**Vertex Pharmaceuticals Incorporated****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)****F. Fair Value of Financial Instruments (Continued)**

enterprise securities. The Company's financial assets valued based on Level 2 inputs consisted of corporate debt securities and commercial paper, which consist of investments in highly-rated investment-grade corporations. During the three and nine months ended September 30, 2012 and 2011, the Company did not record an other-than-temporary impairment charge related to its financial assets. The Company's noncontrolling interest (Alios) includes the fair value of the contingent milestone and royalty payments, which is valued based on Level 3 inputs. Please refer to Note C, "Collaborative Arrangements," for further information.

The following table sets forth the Company's financial assets (excluding Alios' cash equivalents) subject to fair value measurements as of September 30, 2012:

	<b>Fair Value Measurements as of September 30, 2012</b>			
	<b>Total</b>	<b>Fair Value Hierarchy</b>		
		<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
	<b>(in thousands)</b>			
<b>Financial assets carried at fair value:</b>				
<b>Cash equivalents:</b>				
Money market funds	\$ 220,697	\$ 220,697		\$
Government-sponsored enterprise securities	17,568	17,568		
<b>Marketable securities:</b>				
U.S. Treasury securities	222,483	222,483		
Government-sponsored enterprise securities	342,718	342,718		
Commercial paper	251,660		251,660	
Corporate debt securities	44,795		44,795	
Restricted cash	32,166	32,166		
<b>Total</b>	<b>\$ 1,132,087</b>	<b>\$ 835,632</b>	<b>\$ 296,455</b>	<b>\$</b>

Alios' cash equivalents of \$72.7 million as of September 30, 2012 consisted of money market funds, which are valued based on Level 1 inputs.

As of September 30, 2012, the Company had \$400.0 million in aggregate principal amount of 3.35% convertible senior subordinated notes due 2015 (the "2015 Notes") on its condensed consolidated balance sheet. At September 30, 2012, these 2015 Notes had a fair value of approximately \$520 million, based on Level 2 inputs.

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(unaudited)

**G. Marketable Securities**

A summary of the Company's cash, cash equivalents and marketable securities is shown below:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(in thousands)			
<b>As of September 30, 2012</b>				
Cash and cash equivalents:				
Cash and money market funds	\$ 419,318	\$	\$	\$ 419,318
Government-sponsored enterprise securities	17,568			17,568
<b>Total cash and cash equivalents</b>	<b>\$ 436,886</b>	<b>\$</b>	<b>\$</b>	<b>\$ 436,886</b>
Marketable securities:				
U.S. Treasury securities (due within 1 year)	\$ 222,473	\$ 10	\$	\$ 222,483
Government-sponsored enterprise securities (due within 1 year)	342,717	10	(9)	342,718
Commercial paper (due within 1 year)	251,446	214		251,660
Corporate debt securities (due within 1 year)	44,805	1	(11)	44,795
<b>Total marketable securities</b>	<b>\$ 861,441</b>	<b>\$ 235</b>	<b>\$ (20)</b>	<b>\$ 861,656</b>
<b>Total cash, cash equivalents and marketable securities</b>	<b>\$ 1,298,327</b>	<b>\$ 235</b>	<b>\$ (20)</b>	<b>\$ 1,298,542</b>
<b>As of December 31, 2011</b>				
Cash and cash equivalents:				
Cash and money market funds	\$ 362,035	\$	\$	\$ 362,035
Government-sponsored enterprise securities	113,302		(17)	113,285
<b>Total cash and cash equivalents</b>	<b>\$ 475,337</b>	<b>\$</b>	<b>\$ (17)</b>	<b>\$ 475,320</b>
Marketable securities:				
U.S. Treasury securities (due within 1 year)	\$ 22,105	\$ 2	\$	\$ 22,107
Government-sponsored enterprise securities (due within 1 year)	471,589	8	(102)	471,495
<b>Total marketable securities</b>	<b>\$ 493,694</b>	<b>\$ 10</b>	<b>\$ (102)</b>	<b>\$ 493,602</b>
<b>Total cash, cash equivalents and marketable securities</b>	<b>\$ 969,031</b>	<b>\$ 10</b>	<b>\$ (119)</b>	<b>\$ 968,922</b>

Alios' \$75.0 million and \$51.9 million of cash and money market funds as of September 30, 2012 and December 31, 2011, respectively, recorded on the Company's condensed consolidated balance sheets in "Restricted cash and cash equivalents (Alios)," are not included in the above table.

Table of Contents**Vertex Pharmaceuticals Incorporated****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)****H. Inventories**

The following table sets forth the Company's inventories as of September 30, 2012 and December 31, 2011:

	As of September 30, 2012		As of December 31, 2011
	(in thousands)		
Raw materials	\$ 4,506	\$	32,213
Work-in-process	58,452		47,010
Finished goods	23,317		33,207
Total	\$ 86,275	\$	112,430

The Company's inventories as of September 30, 2012 consisted of INCIVEK and KALYDECO inventory costs and as of December 31, 2011 consisted solely of INCIVEK inventory costs. The Company began capitalizing inventory costs for KALYDECO on January 1, 2012.

The Company values its inventories at the lower of cost or market. The Company determines the cost of its inventories, which includes amounts related to materials and manufacturing overhead, on a first-in, first-out basis. The Company performs an assessment of the recoverability of capitalized inventory during each reporting period, and writes down any excess and obsolete inventories to their net realizable value in the period in which the impairment is first identified.

The field of treatment of HCV infection is highly competitive and characterized by rapid technological advances. In the second quarter of 2012, the Company recorded within cost of product revenues a \$78.0 million lower of cost or market charge for excess and obsolete INCIVEK inventories, which included an accrual for estimated expenses related to the Company's non-cancelable purchase commitments. The charge and corresponding inventory write-down were based on the Company's analysis of its INCIVEK inventory levels as of June 30, 2012 in relation to its commercial outlook for INCIVEK. As part of the analysis, the Company considered, among other factors, (i) decreases in demand for INCIVEK and the Company's expectation that demand would decrease further in the second half of 2012, (ii) the potential development by the Company and its competitors of other drugs and combination treatments for HCV infection, (iii) positive results released in the second quarter of 2012 from Phase 2 clinical trials of drug candidates being developed by its competitors and (iv) the initiation by the Company's competitors of a number of additional Phase 2 and Phase 3 clinical trials of drug candidates for the treatment of HCV infection. The \$78.0 million charge in the second quarter of 2012 for excess and obsolete INCIVEK inventories affected the net income (loss) attributable to Vertex per diluted share, net of tax, by \$(0.36) for the nine months ended September 30, 2012.

**I. Fan Pier Leases**

On May 5, 2011, the Company entered into two leases, pursuant to which the Company agreed to lease approximately 1.1 million square feet of office and laboratory space in two buildings (the "Buildings") to be built at Fan Pier in Boston, Massachusetts (the "Fan Pier Leases"). The Company expects to commence lease payments in late 2013 or early 2014, and to make payments for the period ending 15 years from the commencement date. The Company has an option to extend the term of the Fan Pier Leases for an additional ten years.

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**Vertex Pharmaceuticals Incorporated**

**Notes to Condensed Consolidated Financial Statements (Continued)**

**(unaudited)**

**I. Fan Pier Leases (Continued)**

Because the Company is involved in the construction project, including having responsibility to pay for a portion of the costs of finish work and structural elements of the Buildings, the Company is deemed for accounting purposes to be the owner of the Buildings during the construction period. Accordingly, the Company has recorded project construction costs incurred by the landlord as an asset and a related financing obligation in "Fan Pier buildings" and "Construction financing obligation," respectively, on the Company's condensed consolidated balance sheets.

The Company bifurcates its future lease payments pursuant to the Fan Pier Leases into (i) a portion that is allocated to the Buildings and (ii) a portion that is allocated to the land on which the Buildings are being constructed. Although the Company will not begin making lease payments pursuant to the Fan Pier Leases until late 2013 or early 2014, the portion of the lease obligations allocated to the land is treated for accounting purposes as an operating lease that commenced in the second quarter of 2011. During the three and nine months ended September 30, 2012, the Company recorded \$1.6 million and \$5.0 million, respectively, in expense related to this operating lease. During the three and nine months ended September 30, 2011, the Company recorded \$1.7 million and \$2.2 million, respectively, in expense related to this operating lease.

Once the construction of the Buildings is completed, the Company will evaluate the Fan Pier Leases in order to determine whether or not the leases meet the criteria for "sale-leaseback" treatment. If the Fan Pier Leases meet the "sale-leaseback" criteria, the Company will remove the asset and the related liability from its condensed consolidated balance sheet and treat the Fan Pier Leases as either operating or capital leases based on the Company's assessment of the accounting guidance. The Company expects that upon completion of construction of the Buildings the Fan Pier Leases will not meet the "sale-leaseback" criteria. If the Fan Pier Leases do not meet "sale-leaseback" criteria, the Company will treat the Fan Pier Leases as a financing obligation and the asset will be depreciated over its estimated useful life.

**J. Convertible Senior Subordinated Notes due 2015**

In September 2010, the Company completed an offering of \$400.0 million in aggregate principal amount of 2015 Notes. This offering resulted in \$391.6 million of net proceeds to the Company. The underwriting discount of \$8.0 million and other expenses of \$0.4 million were recorded as debt issuance costs and are included in other assets on the Company's condensed consolidated balance sheets. The 2015 Notes were issued pursuant to and are governed by the terms of an indenture (as supplemented, the "Indenture").

The 2015 Notes are convertible at any time, at the option of the holder, into common stock at a price equal to approximately \$48.83 per share, or 20.4794 shares of common stock per \$1,000 principal amount of the 2015 Notes, subject to adjustment. The 2015 Notes bear interest at the rate of 3.35% per annum, and the Company is required to make semi-annual interest payments on the outstanding principal balance of the 2015 Notes on April 1 and October 1 of each year. The 2015 Notes mature on October 1, 2015.

Prior to October 1, 2013, if the closing price of the Company's common stock has exceeded 130% of the then applicable conversion price for at least 20 trading days within a period of 30 consecutive trading days, the Company may redeem the 2015 Notes at its option, in whole or in part, at a

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**Vertex Pharmaceuticals Incorporated**

**Notes to Condensed Consolidated Financial Statements (Continued)**

(unaudited)

**J. Convertible Senior Subordinated Notes due 2015 (Continued)**

redemption price equal to 100% of the principal amount of the 2015 Notes to be redeemed. If the Company elects to redeem the 2015 Notes prior to October 1, 2013, or the holder elects to convert the 2015 Notes into shares of the Company's common stock after receiving notice of such redemption, the Company will be obligated to make an additional payment, payable in cash or, subject to certain conditions, shares of the Company's common stock, so that the Company's total interest payments on the 2015 Notes being redeemed and such additional payment shall equal three years of interest. On or after October 1, 2013, the Company may redeem the 2015 Notes at its option, in whole or in part, at the redemption prices stated in the Indenture plus accrued and unpaid interest, if any, to, but excluding, the redemption date.

Holders may require the Company to repurchase some or all of their 2015 Notes upon the occurrence of certain fundamental changes of Vertex, as set forth in the Indenture, at 100% of the principal amount of the 2015 Notes to be repurchased, plus any accrued and unpaid interest, if any, to, but excluding, the repurchase date.

If a fundamental change occurs that is also a specific type of change of control under the Indenture, the Company will pay a make-whole premium upon the conversion of the 2015 Notes in connection with any such transaction by increasing the applicable conversion rate on such 2015 Notes. The make-whole premium will be in addition to, and not in substitution for, any cash, securities or other assets otherwise due to holders of the 2015 Notes upon conversion. The make-whole premium will be determined by reference to the Indenture and is based on the date on which the fundamental change becomes effective and the price paid, or deemed to be paid, per share of the Company's common stock in the transaction constituting the fundamental change, subject to adjustment.

Based on the Company's evaluation of the 2015 Notes, the Company determined that the 2015 Notes contain a single embedded derivative. This embedded derivative relates to potential penalty interest payments that could be imposed on the Company for a failure to comply with its securities reporting obligations pursuant to the 2015 Notes. This embedded derivative required bifurcation because it was not clearly and closely related to the host instrument. The Company has determined that the value of this embedded derivative was nominal as of September 28, 2010, the issue date of the 2015 Notes, December 31, 2011, and September 30, 2012.

**K. Stock-based Compensation Expense**

The Company issues stock options, restricted stock and restricted stock units with service conditions, which are generally the vesting periods of the awards. The Company also has issued, to certain members of senior management, restricted stock and restricted stock units that vest upon the earlier of the satisfaction of (i) a performance condition or (ii) a service condition, and stock options that vest upon the earlier of the satisfaction of (a) performance conditions or (b) a service condition. In addition, the Company issues shares pursuant to an employee stock purchase plan ("ESPP").

Table of Contents**Vertex Pharmaceuticals Incorporated****Notes to Condensed Consolidated Financial Statements (Continued)**

(unaudited)

**K. Stock-based Compensation Expense (Continued)**

The effect of stock-based compensation expense during the three and nine months ended September 30, 2012 and 2011 was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in thousands)			
Stock-based compensation expense by type of award:				
Stock options	\$ 18,869	\$ 20,610	\$ 59,774	\$ 64,137
Restricted stock and restricted stock units	7,104	7,878	21,643	21,543
ESPP share issuances	1,948	1,220	6,120	4,322
Less stock-based compensation expense capitalized to inventories	(339)	(294)	(888)	(830)
Total stock-based compensation expense included in costs and expenses	\$ 27,582	\$ 29,414	\$ 86,649	\$ 89,172
Stock-based compensation expense by line item:				
Research and development expenses	\$ 17,444	\$ 18,652	\$ 54,425	\$ 57,654
Sales, general and administrative expenses	10,138	10,762	32,224	31,518
Total stock-based compensation expense included in costs and expenses	\$ 27,582	\$ 29,414	\$ 86,649	\$ 89,172

The Company capitalized \$0.3 million and \$0.9 million, respectively, of stock-based compensation expense to inventories, in the three and nine months ended September 30, 2012 and \$0.3 million and \$0.8 million, respectively, of stock-based compensation expense to inventories, in the three and nine months ended September 30, 2011. All of this stock-based compensation expense was attributable to employees who supported the Company's manufacturing operations for the Company's products.

The following table sets forth the Company's unrecognized stock-based compensation expense, net of estimated forfeitures, as of September 30, 2012 by type of award and the weighted-average period over which that expense is expected to be recognized:

Type of award:	As of September 30, 2012	
	Unrecognized Expense Net of Estimated Forfeitures (in thousands)	Weighted-average Recognition Period (in years)
Stock options	\$ 174,454	2.87
Restricted stock and restricted stock units	62,039	2.73
ESPP share issuances	1,176	0.34
	26	

Table of Contents**Vertex Pharmaceuticals Incorporated****Notes to Condensed Consolidated Financial Statements (Continued)**

(unaudited)

**K. Stock-based Compensation Expense (Continued)**

The following table summarizes information about stock options outstanding and exercisable at September 30, 2012:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding (in thousands)	Weighted-average Contractual Life (in years)	Weighted-average Exercise Price (per share)	Number Exercisable (in thousands)	Weighted-average Exercise Price (per share)
\$ 9.07 \$20.00	1,163	3.21	\$ 15.53	1,163	\$ 15.53
\$20.01 \$30.00	1,434	6.60	29.29	1,023	29.08
\$30.01 \$40.00	12,882	7.17	36.10	7,204	35.18
\$40.01 \$50.00	2,327	9.61	48.11	70	44.55
\$50.01 \$60.00	2,355	8.97	53.37	691	54.43
\$60.01 \$64.30	65	9.63	63.10	4	63.10

**L. September 2009 Financial Transactions***2012 Notes*

In September 2009, the Company sold \$155.0 million in aggregate of secured notes due 2012 (the "2012 Notes") for an aggregate of \$122.2 million pursuant to a note purchase agreement with Olmsted Park S.A. (the "Purchaser"). The 2012 Notes were scheduled to mature on October 31, 2012, subject to earlier mandatory redemption to the extent that specified milestone events set forth in the Company's collaboration with Janssen occurred prior to October 31, 2012. In February 2011, the Company received a milestone payment of \$50.0 million and subsequently redeemed \$50.0 million of 2012 Notes pursuant to their terms. The remaining \$105.0 million of 2012 Notes were redeemed on October 31, 2011, with the proceeds of milestone payments received from Janssen in October 2011. The 2012 Notes contained an embedded derivative related to the potential mandatory redemption or early repayment of the 2012 Notes at the face amount prior to their maturity date. The fair value of this embedded derivative was evaluated quarterly, with changes in the fair value of the embedded derivative resulting in a corresponding gain or loss. The Company recorded quarterly interest expense related to the 2012 Notes using the effective interest rate method.

*Sale of Contingent Milestone Payments*

In September 2009, the Company entered into two purchase agreements with the Purchaser pursuant to which the Company sold its rights to an aggregate of \$95.0 million in contingent milestone payments under the Janssen agreement related to the launch of telaprevir in the European Union, for nonrefundable payments totaling \$32.8 million. The Purchaser received the \$95.0 million in milestone payments from Janssen in the fourth quarter of 2011. The Company determined that this sale of a future revenue stream should be accounted for as a liability. The fair value of the rights sold to the Purchaser pursuant to the purchase agreements was evaluated each reporting period until the payments were received in the fourth quarter of 2011, with changes in the fair value of the derivative instruments based on the probability of achieving the milestones, the timing of achieving the milestones or discount rates resulting in a corresponding gain or loss.



Table of Contents**Vertex Pharmaceuticals Incorporated****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)****L. September 2009 Financial Transactions (Continued)***Expenses Related to September 2009 Financial Transactions*

The table below sets forth the total expenses related to the September 2009 financial transactions for the three and nine months ended September 30, 2012 and 2011:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in thousands)			
<b>Expenses and Losses (Gains):</b>				
Interest expense related to 2012 Notes	\$	\$ 2,960	\$	\$ 13,757
Change in fair value of embedded derivative related to 2012 Notes		1,084		(430)
Change in fair value of free-standing derivatives related to the sale of milestone payments		7,031		16,363
<b>Total September 2009 financial transaction expenses</b>	<b>\$</b>	<b>\$ 11,075</b>	<b>\$</b>	<b>\$ 29,690</b>

**M. Sale of HIV Protease Inhibitor Royalty Stream**

In 2008, the Company sold to a third party its rights to receive royalty payments from GlaxoSmithKline plc, net of royalty amounts to be earned by and due to a third party, for a one-time cash payment of \$160.0 million. These royalty payments relate to net sales of HIV protease inhibitors, which had been developed pursuant to a collaboration agreement between the Company and GlaxoSmithKline plc. As of September 30, 2012, the Company had \$84.3 million in deferred revenues related to the one-time cash payment, which it is recognizing over the life of the collaboration agreement with GlaxoSmithKline plc based on the units-of-revenue method. In addition, the Company continues to recognize royalty revenues equal to the amount of the third-party subroyalty and an offsetting royalty expense for the third-party subroyalty payment.

**N. Credit Agreement**

In January 2011, the Company entered into a credit agreement with Bank of America, N.A., as administrative agent and lender. The credit agreement provided for a \$100.0 million revolving credit facility that was unsecured. The Company did not borrow any amount under the credit agreement during its term, which expired on July 6, 2012.

**O. Income Taxes**

In the three months ended September 30, 2012, the Company recorded a benefit from income taxes attributable to Vertex of \$39,000. In the nine months ended September 30, 2012, the Company recorded a provision for income taxes attributable to Vertex of \$1.1 million. These amounts reflect state tax planning implemented during the respective periods. In the three and nine months ended September 30, 2011, the Company recorded a benefit from income taxes attributable to Vertex of \$32.7 million related to the impairment of VX-759.

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**Vertex Pharmaceuticals Incorporated**

**Notes to Condensed Consolidated Financial Statements (Continued)**

(unaudited)

**O. Income Taxes (Continued)**

For the three and nine months ended September 30, 2012, the Company recorded a provision for income taxes attributable to noncontrolling interest (Alios) of \$21.4 million and \$40.4 million, respectively. These provisions primarily were due to the change in fair value of the contingent milestone payments and royalties payable by the Company to Alios during the periods. For the three months ended September 30, 2011, the Company recorded a provision for income taxes attributable to noncontrolling interest (Alios) of \$4.9 million primarily due to the change in fair value of these contingent milestone and royalty payments during the third quarter of 2011. For the nine months ended September 30, 2011, the Company recorded a provision for income taxes attributable to noncontrolling interest (Alios) of \$29.3 million primarily due to the estimated income tax effect on Alios of Vertex's \$60.0 million up-front payment to Alios recorded in the second quarter of 2011. The Company has no liability for taxes payable by Alios. As such, the portion of the income tax provision related to Alios has been allocated to noncontrolling interest (Alios). As of September 30, 2012, Alios had income taxes payable of \$3.9 million and a deferred tax liability of \$151.9 million reflected on the Company's condensed consolidated balance sheet. As of December 31, 2011, Alios had income taxes payable of \$12.1 million and a deferred tax liability of \$116.1 million reflected on the Company's condensed consolidated balance sheet.

As of September 30, 2012 and December 31, 2011, the Company had no material unrecognized tax benefits and no adjustments to liabilities or operations were required. The Company does not expect that its unrecognized tax benefits will materially increase within the next twelve months. The Company did not recognize any material interest or penalties related to uncertain tax positions as of September 30, 2012 and December 31, 2011.

The Company maintains a valuation allowance on its net operating losses and other deferred tax assets because of its extended history of annual losses. The Company's U.S. federal net operating loss carryforwards totaled approximately \$2.7 billion as of December 31, 2011. On a quarterly basis, the Company reassesses the valuation allowance for deferred income tax assets. The Company would consider reversing a significant portion of the valuation allowance upon assessment of certain factors, including (i) a demonstration of sustained profitability and (ii) the support of internal financial forecasts demonstrating the utilization of the net operating loss carryforwards prior to their expiration. If the Company determines that the reversal of all or a portion of the valuation allowance is appropriate, a significant benefit could be recognized against its income tax provision in the period of the reversal.

The Company files U.S. federal income tax returns and income tax returns in various state, local and foreign jurisdictions. The Company is no longer subject to any tax assessment from an income tax examination in the United States before 2007 and any other major taxing jurisdiction for years before 2005, except where the Company has net operating losses or tax credit carryforwards that originated before 2005. The Company currently is under examination by Revenue Quebec for the year ended March 11, 2009 and the year ended December 31, 2007. No adjustments have been reported. The Company is not under examination by any other jurisdictions for any tax year.

The Company intends to reinvest the total amount of its unremitted earnings in the local international jurisdiction or to repatriate the earnings only when tax-effective. As such, the Company has not provided for U.S. federal income taxes on the unremitted earnings of its international subsidiaries. Upon repatriation of those earnings, in the form of dividends or otherwise, the Company

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**Vertex Pharmaceuticals Incorporated**

**Notes to Condensed Consolidated Financial Statements (Continued)**

(unaudited)

**O. Income Taxes (Continued)**

would be subject to U.S. federal income taxes (subject to an adjustment for foreign tax credits) and withholding taxes payable to the various foreign countries. Determination of the amount of the unrecognized deferred U.S. federal income tax liability is not practical due to the complexity associated with this hypothetical calculation; however, unrecognized foreign tax credits would be available to reduce some portion of the U.S. federal income tax liability.

**P. Restructuring Expense**

In June 2003, Vertex adopted a plan to restructure its operations to coincide with its increasing internal emphasis on advancing drug candidates through clinical development to commercialization. The restructuring was designed to re-balance the Company's relative investments in research and development to better support the Company's long-term strategy. At that time, the restructuring plan included a workforce reduction, write-offs of certain assets and a decision not to occupy approximately 290,000 square feet of specialized laboratory and office space in Cambridge, Massachusetts under lease to Vertex (the "Kendall Square Lease"). The Kendall Square Lease commenced in January 2003 and has a 15-year term. In the second quarter of 2005, the Company revised its assessment of its real estate requirements and decided to use approximately 120,000 square feet of the facility subject to the Kendall Square Lease (the "Kendall Square Facility") for its operations, beginning in 2006. The remaining rentable square footage of the Kendall Square Facility currently is subleased to third parties.

The restructuring expense incurred in the three and nine months ended September 30, 2012 and 2011 relates only to the portion of the Kendall Square Facility that the Company is not occupying and does not intend to occupy for its operations. The remaining lease obligations, which are associated with the portion of the Kendall Square Facility that the Company occupies and uses for its operations, are recorded as rental expense in the period incurred.

In estimating the expense and liability under its Kendall Square Lease obligation, the Company estimated (i) the costs to be incurred to satisfy rental and build-out commitments under the lease (including operating costs), (ii) the lead-time necessary to sublease the space, (iii) the projected sublease rental rates and (iv) the anticipated durations of subleases. The Company uses a credit-adjusted risk-free rate of approximately 10% to discount the estimated cash flows. The Company reviews its estimates and assumptions on at least a quarterly basis, and intends to continue such reviews until the termination of the Kendall Square Lease, and will make whatever modifications the Company believes necessary, based on the Company's best judgment, to reflect any changed circumstances. The Company's estimates have changed in the past, and may change in the future, resulting in additional adjustments to the estimate of the liability. Changes to the Company's estimate of the liability are recorded as additional restructuring expense (credit). In addition, because the Company's estimate of the liability includes the application of a discount rate to reflect the time-value of money, the Company records imputed interest costs related to the liability each quarter. These costs are included in restructuring expense (credit) on the Company's condensed consolidated statements of operations.

In each period, the Company records lease restructuring expense attributable to imputed interest related to the restructuring liability. In certain periods, the restructuring expense also reflects the revision of certain key estimates and assumptions about building operating expenses and sublease

Table of Contents**Vertex Pharmaceuticals Incorporated****Notes to Condensed Consolidated Financial Statements (Continued)**

(unaudited)

**P. Restructuring Expense (Continued)**

income. The activities related to the restructuring liability for the three and nine months ended September 30, 2012 and 2011 were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in thousands)			
Liability, beginning of the period	\$ 24,830	\$ 28,205	\$ 26,313	\$ 29,595
Cash payments	(3,726)	(3,685)	(11,137)	(11,158)
Cash received from subleases	2,355	2,483	7,329	7,065
Restructuring expense (credit)	696	(419)	1,650	1,082
Liability, end of the period	\$ 24,155	\$ 26,584	\$ 24,155	\$ 26,584

**Q. Legal Proceedings**

On September 6, 2012, a purported shareholder class action, *City of Bristol Pension Fund v. Vertex Pharmaceuticals Incorporated, et al.*, was filed in the United States District Court for the District of Massachusetts, naming the Company and certain officers and directors of the Company as defendants. The lawsuit alleges that the Company made material misrepresentations and/or omissions of material fact in the Company's disclosures during the period from May 7, 2012 through June 28, 2012, all in violation of Section 10(b) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder. The plaintiffs seek unspecified damages on behalf of the putative class, unspecified injunctive relief and an award of costs and expenses, including attorney's fees. The Company believes that this action is without merit and intends to defend it vigorously. As of September 30, 2012, the Company has not recorded any reserves for this purported class action.

**R. Contingencies**

The Company has certain contingent liabilities that arise in the ordinary course of its business activities. The Company accrues a reserve for contingent liabilities when it is probable that future expenditures will be made and such expenditures can be reasonably estimated. There were no material contingent liabilities accrued as of September 30, 2012 or December 31, 2011.

**S. Guarantees**

As permitted under Massachusetts law, the Company's Articles of Organization and By-laws provide that the Company will indemnify certain of its officers and directors for certain claims asserted against them in connection with their service as an officer or director. The maximum potential amount of future payments that the Company could be required to make under these indemnification provisions is unlimited. However, the Company has purchased directors' and officers' liability insurance policies that could reduce its monetary exposure and enable it to recover a portion of any future amounts paid. No indemnification claims currently are outstanding, and the Company believes the estimated fair value of these indemnification arrangements is minimal.

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**Vertex Pharmaceuticals Incorporated**

**Notes to Condensed Consolidated Financial Statements (Continued)**

(unaudited)

**S. Guarantees (Continued)**

The Company customarily agrees in the ordinary course of its business to indemnification provisions in agreements with clinical trial investigators and sites in its drug development programs, sponsored research agreements with academic and not-for-profit institutions, various comparable agreements involving parties performing services for the Company and its real estate leases. The Company also customarily agrees to certain indemnification provisions in its drug discovery, development and commercialization collaboration agreements. With respect to the Company's clinical trials and sponsored research agreements, these indemnification provisions typically apply to any claim asserted against the investigator or the investigator's institution relating to personal injury or property damage, violations of law or certain breaches of the Company's contractual obligations arising out of the research or clinical testing of the Company's compounds or drug candidates. With respect to lease agreements, the indemnification provisions typically apply to claims asserted against the landlord relating to personal injury or property damage caused by the Company, to violations of law by the Company or to certain breaches of the Company's contractual obligations. The indemnification provisions appearing in the Company's collaboration agreements are similar to those for the other agreements discussed above, but in addition provide some limited indemnification for its collaborator in the event of third-party claims alleging infringement of intellectual property rights. In each of the cases above, the indemnification obligation generally survives the termination of the agreement for some extended period, although the Company believes the obligation typically has the most relevance during the contract term and for a short period of time thereafter. The maximum potential amount of future payments that the Company could be required to make under these provisions is generally unlimited. The Company has purchased insurance policies covering personal injury, property damage and general liability that reduce its exposure for indemnification and would enable it in many cases to recover all or a portion of any future amounts paid. The Company has never paid any material amounts to defend lawsuits or settle claims related to these indemnification provisions. Accordingly, the Company believes the estimated fair value of these indemnification arrangements is minimal.

The Company entered into an underwriting agreement with Merrill Lynch, Pierce, Fenner & Smith Incorporated dated September 23, 2010 (the "Underwriting Agreement"), relating to the public offering and sale of the 2015 Notes. The Underwriting Agreement requires the Company to indemnify the underwriter against any loss it may suffer by reason of the Company's breach of any representation or warranty relating to the public offering, the Company's failure to perform certain covenants in the Underwriting Agreement, the inclusion of any untrue statement of material fact in the prospectus used in connection with the offering, the omission of any material fact needed to make those materials not misleading and any actions taken by the Company or its representatives in connection with the offering. The representations, warranties, covenants and indemnification provisions in the Underwriting Agreement are of a type customary in agreements of this sort. The Company believes the estimated fair value of this indemnification arrangement is minimal.

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

**Overview**

We are in the business of discovering, developing, manufacturing and commercializing small molecule drugs for the treatment of serious diseases. Our two products are INCIVEK (telaprevir), which is approved in the United States and Canada for the treatment of adults with genotype 1 hepatitis C virus, or HCV, infection, and KALYDECO (ivacaftor), which is approved in the United States and European Union for the treatment of patients six years of age or older with cystic fibrosis, or CF, who have a specific mutation that is referred to as the G551D mutation. We obtained approval to market KALYDECO in the United States in January 2012 and in the European Union in July 2012. Our collaborator, Janssen Pharmaceutica, N.V., or Janssen, markets telaprevir in Europe and its other territories under the brand name INCIVO, and our collaborator, Mitsubishi Tanabe Pharma Corporation, or Mitsubishi Tanabe, markets telaprevir in Japan under the brand name TELAVIC.

As of September 30, 2012, we had cash, cash equivalents and marketable securities, excluding Alios' cash and cash equivalents, of \$1.3 billion. Our net product revenues decreased from \$373.3 million in the second quarter of 2012 to \$303.5 million in the third quarter of 2012 due to decreased INCIVEK net product revenues partially offset by a small increase in KALYDECO net product revenues. We expect these trends to continue with KALYDECO revenues increasing as a result of its recent approval in the European Union and INCIVEK revenues decreasing in future periods.

We believe that our long-term success will depend on our ability to continue to generate and develop innovative molecules for the treatment of serious diseases. We have ongoing clinical programs involving drug candidates intended for the treatment of HCV infection, CF, rheumatoid arthritis and influenza. Our HCV clinical programs are focused on developing all-oral, interferon-free combinations of HCV drugs and drug candidates that have the potential to further improve treatment options available to patients with HCV infection and fulfilling INCIVEK post-marketing commitments to regulatory agencies. We plan to evaluate multiple all-oral treatment regimens incorporating our HCV nucleotide analogue VX-135 (formerly referred to as ALS-2200), including combinations of VX-135 with GlaxoSmithKline plc's, or GlaxoSmithKline's, investigational HCV NS5A inhibitor GSK2336805 and VX-135 with Janssen Pharmaceuticals, Inc.'s investigational HCV protease inhibitor simeprevir (TMC435). In our CF program, we are investigating the use of ivacaftor as a monotherapy in additional populations of patients with CF, and combinations of ivacaftor and our other CF drug candidates, with the goal of expanding the group of patients with CF who can benefit from our medicines. We also plan to initiate a pivotal clinical program to evaluate ivacaftor in combination with VX-809 in CF patients with two copies of the F508del mutation in the cystic fibrosis transmembrane conductance regulator, or *CFTR*, gene, pending discussions with regulatory agencies. We expect to continue investing in research programs directed toward identifying new drug candidates and to develop and commercialize selected drug candidates that emerge from those programs, alone or with third-party collaborators.

*Competition*

HCV

The field of HCV infection treatment is highly competitive and characterized by rapid technological advances. We and Janssen are competing with Merck & Co., Inc.'s VICTRELIS (boceprevir), another HCV protease inhibitor that was approved for sale in the United States and Europe in 2011. Increased competition from currently approved drugs, the introduction of new competitive drugs or drug combinations, adverse information regarding the safety characteristics or efficacy of the drug, significant new information regarding potential future treatment regimens that are being evaluated in clinical trials or enrollment by patients in clinical trials being conducted by us or our competitors could result in abrupt shifts in the HCV market. We, along with a number of our competitors, are pursuing development programs involving all-oral combinations of HCV drugs and

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drug candidates with the goal of developing improved treatment regimens for HCV infection that could render uncompetitive current and future treatment regimens that include the administration of pegylated-interferon, or peg-IFN, by injection. To date, potential all-oral combination treatment regimens have been evaluated in Phase 2 clinical trials involving relatively small numbers of patients.

Several of our competitors are conducting Phase 3 clinical trials evaluating their drug candidates for the treatment of genotype 1 HCV infection, including clinical trials evaluating all-oral combinations and combinations that include peg-IFN. Gilead Sciences, Inc., or Gilead, is evaluating its HCV nucleotide analogue, GS-7977, in Phase 3 clinical trials, both in combination with peg-IFN and ribavirin and as part of an all-oral combination regimen. In October 2012, Abbott Laboratories initiated its first Phase 3 clinical trial to evaluate an all-oral combination of its HCV drug candidates. Janssen is evaluating simeprevir (TMC435) in combination with peg-IFN and ribavirin in Phase 3 clinical trials that were initiated in early 2011. In addition, many other competitors are evaluating drug candidates for the treatment of HCV infection, which are at various stages of development. While the development and regulatory timelines for drug candidates for the treatment of HCV infection are subject to risk and uncertainty and the effects of the advancement of these competitive treatment regimens are difficult to predict, we believe that (i) substantial additional clinical data regarding these drug candidates and potential all-oral treatment regimens will become available in late 2012 and in 2013, (ii) one or more of these drug candidates could be approved in the second half of 2013 or early 2014 and (iii) one or more all-oral treatment regimens could be commercially available as early as 2014.

CF

KALYDECO (ivacaftor) is approved in the United States and the European Union for the treatment of patients with CF six years of age or older who have the G551D mutation on at least one allele of the *CFTR* gene. Following approval in the European Union, we are working with national health authorities to arrange for reimbursement so that we will be able to provide KALYDECO to eligible patients in Europe. Ivacaftor has received Priority Review from the Therapeutic Product Directorate of Health Canada, and we have submitted a marketing authorization application for ivacaftor to the Therapeutic Goods Administration of Australia. We recently initiated two Phase 3 clinical trials to evaluate ivacaftor as a monotherapy in CF patients with mutations other than the G551D mutation, and a Phase 3 clinical trial of ivacaftor as a monotherapy in CF patients two to five years of age who have a gating mutation in the *CFTR* gene. If these clinical trials are successful, we expect we would obtain approval for the use of ivacaftor in additional populations in 2013 or later.

We are aware of several companies that are engaged in researching and/or developing treatments for CF, including Genzyme Corporation, which has a research program directed at identifying *CFTR* corrector compounds. We believe that the programs that could result in drugs that are directly competitive with KALYDECO or the combination treatment regimens that we are developing are several years behind our programs.

In addition to the factors described above, approved drugs continue to be subject to, among other things, numerous regulatory risks, post-approval safety monitoring and risks related to supply chain disruptions.

*Drug Supply and INCIVEK Inventory Write-down*

We rely on an international network of third parties to manufacture and distribute our products and for supplies of compounds for clinical trials, and we expect that we will continue to rely on third parties to provide these manufacturing services for the foreseeable future. Third-party contract manufacturers, including some in China, supply us with raw materials, and contract manufacturers in the European Union and the United States convert these raw materials into drug substance and

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convert the drug substance into final dosage form. Establishing and managing this global supply chain requires a significant financial commitment and the creation and maintenance of numerous third-party relationships. Although we believe we effectively manage the business relationships with companies in our supply chain, we do not have complete control over their activities. Also, we have limited flexibility to adjust our supply of INCIVEK in response to changes in demand, due to the significant lead times required to manufacture INCIVEK.

In the second quarter of 2012, following a periodic assessment of the recoverability of capitalized costs, we recorded within cost of product revenues a \$78.0 million charge for excess and obsolete INCIVEK inventories. Periodic assessments of the recoverability of capitalized costs involve significant estimates and judgments on the part of management. The charge and corresponding inventory write-down were based on our analysis of our INCIVEK inventory levels in relation to our commercial outlook for INCIVEK. As part of the analysis, we considered, among other factors, (i) decreases in demand for INCIVEK and our expectation that demand would decrease further in the second half of 2012, (ii) the potential development by us and our competitors of other drugs and combination treatments for HCV infection, (iii) positive results released in the second quarter of 2012 from Phase 2 clinical trials of drug candidates being developed by our competitors and (iv) the initiation by our competitors of a number of additional Phase 2 and Phase 3 clinical trials of drug candidates for the treatment of HCV infection. We will evaluate our INCIVEK inventories on a quarterly basis, and future changes in the outlook for commercial sales of INCIVEK, including changes due to future developments with respect to demand for INCIVEK or the advancement or approval of other drugs or combination treatments for HCV infection, could result in additional inventory write-downs and related charges in future periods.

*Regulatory Compliance*

Our marketing of pharmaceutical products, which began in North America in 2011 and in the European Union in the third quarter of 2012, is subject to extensive and complex laws and regulations. We have a corporate compliance program designed to promote a culture of compliance and to actively identify, prevent and mitigate risk. Among other laws, regulations and standards, we are subject to various U.S. federal and state laws and comparable foreign laws pertaining to health care fraud and abuse, including anti-kickback and false claims statutes, and laws prohibiting the promotion of drugs for unapproved, or off-label, uses. Anti-kickback laws make it illegal for a prescription drug manufacturer to solicit, offer, receive or pay any remuneration in exchange for, or to induce, the referral of business, including the purchase or prescription of a particular drug. False claims laws prohibit anyone from presenting for payment to third-party payors, including Medicare and Medicaid, claims for reimbursed drugs or services that are false or fraudulent, claims for items or services not provided as claimed or claims for medically unnecessary items or services. We expect to continue to devote substantial resources to maintain, administer and expand these compliance programs globally.

*Recent Developments*

**HCV**

*VX-135*

We are planning to evaluate VX-135 in multiple all-oral treatment regimens for patients with genotype 1 HCV infection:

In October 2012, we entered two separate, non-exclusive collaborations with GlaxoSmithKline and Janssen Pharmaceuticals, Inc. GlaxoSmithKline and we plan to evaluate VX-135 in combination with GlaxoSmithKline's investigational NS5A inhibitor GSK2336805 in a Phase 2 clinical trial expected to be initiated in early 2013, pending discussions with regulatory authorities. Janssen and we plan to evaluate VX-135 in combination with Janssen's



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investigational protease inhibitor simeprevir (TMC435). Janssen will conduct a drug-drug interaction trial with VX-135 and simeprevir to support the planned initiation of a Phase 2 clinical trial in early 2013, pending discussions with regulatory authorities. We will jointly fund development costs associated with each collaboration, and no further clinical development activities are covered under either agreement beyond the planned Phase 2 clinical trials.

We plan to conduct Phase 2 clinical trials to evaluate VX-135 in combination with ribavirin and VX-135 in combination with telaprevir. We expect to initiate the clinical trial to evaluate VX-135 and ribavirin by the end of 2012, followed by the clinical trial to evaluate VX-135 in combination with telaprevir in early 2013.

*ALS-2158*

In September 2012, we announced the results of a Phase 1 clinical trial to evaluate the safety, tolerability and effects on viral kinetics of ALS-2158, the second HCV nucleotide analogue that we were developing in collaboration with Alios. Data from this clinical trial showed that seven days of dosing with up to 900 mg of ALS-2158 was well-tolerated in patients with genotype 1 HCV infection, but that there was insufficient antiviral activity to warrant proceeding with further clinical development.

*Telaprevir*

Janssen recently completed a clinical trial evaluating twice-daily dosing for telaprevir. The results from this clinical trial demonstrated that twice-daily dosing of telaprevir in combination with peg-IFN and ribavirin resulted in similar sustained virological response rates to dosing with telaprevir every eight hours in combination with peg-IFN and ribavirin, which is the currently approved dosing regimen. Adverse events were generally similar between both arms of the clinical trial and consistent with previous clinical trials of telaprevir in combination with peg-IFN and ribavirin. We plan to submit data supporting this new twice-daily dosing regimen to the United States Food and Drug Administration in 2013 for potential inclusion in the telaprevir label in the United States.

**Cystic Fibrosis**

*Ivacaftor*

We are conducting four clinical trials to evaluate ivacaftor as a monotherapy in patients with CF:

In July 2012, we initiated a Phase 3 clinical trial to evaluate ivacaftor in patients with CF six years of age or older who have at least one copy of the R117H mutation in the *CFTR* gene and a Phase 3 clinical trial of patients with CF six years of age or older who have at least one non-G551D gating mutation in the *CFTR* gene. We recently initiated a Phase 3 clinical trial to evaluate ivacaftor in patients with CF two to five years of age who have a gating mutation in the *CFTR* gene, with enrollment targeted to begin by the end of 2012.

We are conducting a Phase 2 clinical trial to evaluate the safety and efficacy of ivacaftor as a monotherapy in patients 12 years of age or older who have clinical evidence of residual CFTR function.

*VX-809/Ivacaftor*

Based on data from the second part of an ongoing Phase 2 clinical trial and pending discussions with regulatory agencies, we are preparing to initiate in early 2013 a pivotal clinical trial program to evaluate VX-809 in combination with ivacaftor in patients with two copies of the F508del mutation in the *CFTR* gene. A third part of the ongoing Phase 2 clinical trial is evaluating the pharmacokinetics, safety and tolerability of a twice-daily combination of VX-809 and ivacaftor. The third part of the

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ongoing Phase 2 clinical trial is fully-enrolled, and we expect to use data from the third part of the clinical trial to support the pivotal program for VX-809 and ivacaftor.

*VX-661/Ivacaftor*

A Phase 2 clinical trial of VX-661, a second CFTR corrector, which is being evaluated in combination with ivacaftor for patients with CF homozygous for the F508del mutation, is ongoing, with final data expected in the first half of 2013.

**Rheumatoid Arthritis**

We are enrolling patients with moderate to severe rheumatoid arthritis in a Phase 2b clinical trial evaluating once-daily and twice-daily doses of VX-509 over a six-month dosing period. We expect to enroll approximately 350 patients in this clinical trial. VX-509 is being evaluated in combination with methotrexate, a commonly prescribed disease-modifying antirheumatic drug that frequently is used in combination with other rheumatoid arthritis drugs. We also are preparing to initiate additional clinical trials of VX-509 in other immune-mediated inflammatory diseases in 2013.

**Influenza**

We expect to receive final data in the fourth quarter of 2012 from an ongoing Phase 2 clinical trial of VX-787 that is expected to enroll approximately 140 healthy volunteers who are being infected with live influenza virus as part of this clinical trial. We are evaluating VX-787 as a potential treatment for influenza A, including recent H1N1 (pandemic) and H5N1 (avian) influenza strains.

**Epilepsy**

In the third quarter of 2012, we ended clinical development of VX-765.

Table of Contents**Results of Operations Three and Nine Months Ended September 30, 2012 Compared with Three and Nine Months Ended September 30, 2011**

	Three Months Ended September 30,		Increase/ (Decrease)	Increase/ (Decrease)	Nine Months Ended September 30,		Increase/ (Decrease)	Increase/ (Decrease)
	2012	2011	\$	%	2012	2011	\$	%
	(in thousands)				(in thousands)			
Revenues	\$ 336,006	\$ 659,200	\$ (323,194)	(49)%	\$ 1,193,048	\$ 847,286	\$ 345,762	41%
Operating costs and expenses	337,077	443,493	(106,416)	(24)%	1,113,240	957,368	155,872	16%
Other income (loss), net	(25,396)	12,745	n/a	n/a	(52,867)	(36,880)	15,987	43%
Net loss (income) attributable to noncontrolling interest (Alios)	(31,076)	(7,342)	23,734	323%	(57,825)	17,907	n/a	n/a
Net income (loss) attributable to Vertex	\$ (57,543)	\$ 221,110	n/a	n/a	\$ (30,884)	\$ (129,055)	\$ (98,171)	(76)%

***Net Income (Loss) Attributable to Vertex***

In the third quarter of 2012, we had a net loss attributable to Vertex of \$(57.5) million as compared to net income attributable to Vertex of \$221.1 million in the third quarter of 2011. Our total revenues decreased in the third quarter of 2012 compared to the third quarter of 2011 from \$659.2 million to \$336.0 million due to a \$116.1 million decrease in our net product revenues and a \$224.1 million decrease in our collaborative revenues. Our operating costs and expenses decreased from \$443.5 million, including \$29.4 million of stock-based compensation expense, in the third quarter of 2011 to \$337.1 million, including \$27.6 million of stock-based compensation expense, in the third quarter of 2012. The decrease in operating costs and expenses in the third quarter of 2012 compared to the third quarter of 2011 was primarily due to an intangible asset impairment charge of \$105.8 million recorded in the third quarter of 2011 for which there was no corresponding charge in the third quarter of 2012. Each reporting period we estimate the fair value of the contingent milestone payments and royalties payable by us to Alios. Any increase in the fair value of these contingent milestone and royalty payments results in a decrease in net income attributable to Vertex (or an increase in net loss attributable to Vertex) on a dollar-for-dollar basis. In the three months ended September 30, 2012 and 2011, the fair value of these contingent milestone and royalty payments increased by \$57.6 million and \$17.5 million, respectively.

In the nine months ended September 30, 2012, we had a net loss attributable to Vertex of \$(30.9) million as compared to a net loss attributable to Vertex of \$(129.1) million in the nine months ended September 30, 2011. Our total revenues increased in the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011 due to a \$558.0 million increase in our net product revenues and a \$73.4 million increase in our royalty revenues, partially offset by a \$285.7 million decrease in our collaborative revenues. Our operating costs and expenses increased from \$957.4 million, including \$89.2 million of stock-based compensation expense, in the nine months ended September 30, 2011 to \$1.1 billion, including \$86.6 million of stock-based compensation expense, in the nine months ended September 30, 2012. The increase in operating costs and expenses was primarily due to a \$120.5 million increase in cost of product revenues, which included a \$78.0 million charge in the second quarter of 2012 for excess and obsolete INCIVEK inventories, as well as a \$71.8 million increase in research and development expenses, a \$47.5 million increase in sales, general and administrative expenses, and a \$21.3 million increase in royalty expenses, partially offset by an intangible asset impairment charge of \$105.8 million recorded in third quarter of 2011. Any increase in

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the fair value of the contingent milestone payments and royalties payable by us to Alios results in a decrease in net income attributable to Vertex (or an increase in net loss attributable to Vertex) on a dollar-for-dollar basis. In the nine months ended September 30, 2012 and 2011, the fair value of these contingent milestone and royalty payments increased by \$112.8 million and \$17.5 million, respectively.

**Net Income (Loss) Attributable to Vertex per Diluted Share**

Net loss attributable to Vertex was \$(0.27) per diluted share in the third quarter of 2012, compared to net income attributable to Vertex of \$1.02 per diluted share in the third quarter of 2011. Net loss attributable to Vertex was \$(0.15) and \$(0.63), respectively, per diluted share in the nine months ended September 30, 2012 and 2011.

**Revenues**

	Three Months Ended September 30,		Increase/ (Decrease)	Increase/ (Decrease)	Nine Months Ended September 30,		Increase/ (Decrease)	Increase/ (Decrease)
	2012	2011	\$	%	2012	2011	\$	%
	(in thousands)				(in thousands)			
Product revenues, net	\$ 303,501	\$ 419,595	\$ (116,094)	(28)%	\$ 1,052,149	\$ 494,130	\$ 558,019	113%
Royalty revenues	25,586	8,539	17,047	200%	98,047	24,610	73,437	298%
Collaborative revenues	6,919	231,066	(224,147)	(97)%	42,852	328,546	(285,694)	(87)%
Total revenues	\$ 336,006	\$ 659,200	\$ (323,194)	(49)%	\$ 1,193,048	\$ 847,286	\$ 345,762	41%

**Product Revenues, Net**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in thousands)			
Product revenues, net				
INCIVEK	\$ 254,340	\$ 419,595	\$ 939,006	\$ 494,130
KALYDECO	49,161		113,143	
Total product revenues, net	\$ 303,501	\$ 419,595	\$ 1,052,149	\$ 494,130

Our net product revenues in the third quarter of 2012 decreased from our net product revenues in third quarter of 2011 due to a \$165.3 million decrease in INCIVEK net product revenues partially offset by a \$49.2 million increase in KALYDECO net product revenues.

Our net product revenues in the nine months ended September 30, 2012 increased from our net product revenues in the nine months ended September 30, 2011. Revenues in the nine months ended September 30, 2012 included revenues from both INCIVEK, which we began marketing in the United States in the second quarter of 2011, and KALYDECO, which we began marketing in the United States in the first quarter of 2012 and in certain countries in the European Union in the third quarter of 2012. Our net product revenues in the comparable period in 2011 consisted of net product revenues from INCIVEK for the period from its approval on May 23, 2011 through September 30, 2011.

Our net product revenues decreased by \$69.8 million from \$373.3 million in the second quarter of 2012 to \$303.5 million in the third quarter of 2012, due to a \$73.4 million decrease in net product revenues from INCIVEK partially offset by a \$3.6 million increase in net product revenues from KALYDECO. We expect that INCIVEK net product revenues will continue to decrease due to competitive pressures, and that these decreases will be partially offset by expected increases in KALYDECO net product revenues.

Table of Contents**Royalty Revenues**

The increases in our royalty revenues in the three and nine months ended September 30, 2012 as compared to the comparable periods in 2011 were due to royalty revenues recognized from sales of INCIVO by Janssen. INCIVO was approved in the European Union in September 2011, and we recognized \$20.0 million and \$80.8 million, respectively, of royalty revenues from Janssen in the three and nine months ended September 30, 2012. Royalty revenues from Janssen decreased by \$8.0 million from \$28.0 million in the second quarter of 2012 to \$20.0 million in the third quarter of 2012. INCIVO faces competitive pressures similar to those facing INCIVEK, and we expect that INCIVO royalty revenues will continue to decline in future periods. Mitsubishi Tanabe's license to market telaprevir in Japan is fully paid.

We recognized royalty revenues related to sales by GlaxoSmithKline of Lexiva/Telzir, an HIV protease inhibitor that was discovered and developed pursuant to our collaboration with GlaxoSmithKline, of \$5.6 million and \$7.3 million, respectively, in the three months ended September 30, 2012 and 2011, and \$17.2 million and \$20.8 million, respectively, in the nine months ended September 30, 2012 and 2011. We sold our rights to these HIV royalties in 2008 for a one-time cash payment of \$160.0 million.

**Collaborative Revenues**

Our collaborative revenues have fluctuated significantly on an annual and quarterly basis. This variability has been due to, among other things, (i) the achievement of significant milestone revenues in 2011, (ii) the April 2011 amendment to our collaboration agreement with the Cystic Fibrosis Foundation Therapeutics Incorporated, or CFFT, which began providing us additional research and development support in April 2011 and (iii) variable revenues we received for providing services to Janssen and Mitsubishi Tanabe through our third-party manufacturing network.

The following table summarizes our collaborative revenues for the three and nine months ended September 30, 2012 and 2011:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in thousands)			
Collaborative revenues:				
Janssen	\$ 2,604	\$ 207,720	\$ 11,201	\$ 272,894
Mitsubishi Tanabe		19,500	18,879	45,858
CFFT	4,315	3,846	12,772	9,794
Total collaborative revenues	\$ 6,919	\$ 231,066	\$ 42,852	\$ 328,546

Our collaborative revenues from Janssen decreased significantly in the three and nine months ended September 30, 2012 as compared to the three and nine months ended September 30, 2011 because we recognized \$200.0 million and \$250.0 million, respectively, in the three and nine months ended September 30, 2011, in milestone revenues under our collaboration agreement with Janssen, for which there were no comparable milestone revenues in the three and nine months ended September 30, 2012. We do not expect to earn any future milestone payments pursuant to this collaboration agreement with Janssen.

In the second quarter of 2012, we recognized the final \$3.2 million of deferred revenues related to a one-time payment of \$105.0 million that we received in 2009 from Mitsubishi Tanabe. From the fourth quarter of 2009 through the first quarter of 2012, we recognized \$9.6 million in collaborative revenues each quarter related to this one-time payment. We did not recognize any collaborative

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revenues from Mitsubishi Tanabe in the third quarter of 2012 and do not expect to recognize any future collaborative revenues pursuant to our collaboration agreement with Mitsubishi Tanabe.

**Operating Costs and Expenses**

	Three Months Ended September 30,		Increase/ (Decrease)	Increase/ (Decrease)	Nine Months Ended September 30,		Increase/ (Decrease)	Increase/ (Decrease)	
	2012	2011	\$	%	2012	2011	\$	%	
	(in thousands)		(in thousands)						
Cost of product revenues	\$ 30,680	\$ 35,285	\$ (4,605)	(13)%	\$ 161,147	\$ 40,689	\$ 120,458	296%	
Royalty expenses	7,856	3,121	4,735	152%	31,023	9,689	21,334	220%	
Research and development expenses	200,161	189,052	11,109	6%	593,076	521,268	71,808	14%	
Sales, general and administrative expenses	97,684	110,654	(12,970)	(12)%	326,344	278,840	47,504	17%	
Restructuring expense (credit)	696	(419)	n/a	n/a	1,650	1,082	568	53%	
Intangible asset impairment charge		105,800	(105,800)	(100)%		105,800	(105,800)	(100)%	
<b>Total costs and expenses</b>	<b>\$ 337,077</b>	<b>\$ 443,493</b>	<b>\$ (106,416)</b>	<b>(24)%</b>	<b>\$ 1,113,240</b>	<b>\$ 957,368</b>	<b>\$ 155,872</b>	<b>16%</b>	

**Cost of Product Revenues**

Our cost of product revenues includes in each period the cost of producing inventories that corresponds to product revenues for the reporting period, plus the third-party royalties payable on our net sales of INCIVEK and KALYDECO. Most of the manufacturing costs of INCIVEK and KALYDECO sold in the periods presented were expensed as research and development expenses in prior periods. Our cost of product revenues decreased in the third quarter of 2012 compared to the third quarter of 2011 as a result of lower net product revenues partially offset by the cost of a commercial milestone earned by CFFT in the third quarter of 2012. In the second quarter of 2012, we recorded within cost of product revenues a \$78.0 million charge for excess and obsolete INCIVEK inventories. We evaluate our INCIVEK inventories on a quarterly basis, and future changes in the outlook for commercial sales of INCIVEK could result in additional inventory write-downs in future periods, which would be recorded as part of cost of product revenues.

**Royalty Expenses**

Royalty expenses include third-party royalties payable by us on net sales of telaprevir by our collaborators and a subroyalty payable to a third party on net sales of Lexiva/Telzir, an HIV protease inhibitor sold by GlaxoSmithKline. Royalty expenses in the three and nine months ended September 30, 2012 increased compared to the three and nine months ended September 30, 2011 primarily because of an increase in the third-party royalties payable on net sales of INCIVO by Janssen.

Table of Contents**Research and Development Expenses**

	Three Months Ended September 30,		Increase/ (Decrease)	Increase/ (Decrease)	Nine Months Ended September 30,		Increase/ (Decrease)	Increase/ (Decrease)	
	2012	2011	\$	%	2012	2011	\$	%	
	(in thousands)		(in thousands)						
Research expenses	\$ 56,400	\$ 57,444	\$ (1,044)	(2)%	\$ 175,888	\$ 160,548	\$ 15,340	10%	
Development expenses	143,761	131,608	12,153	9%	417,188	360,720	56,468	16%	
<b>Total research and development expenses</b>	<b>\$ 200,161</b>	<b>\$ 189,052</b>	<b>\$ 11,109</b>	<b>6%</b>	<b>\$ 593,076</b>	<b>\$ 521,268</b>	<b>\$ 71,808</b>	<b>14%</b>	

Our research and development expenses include internal and external costs incurred for research and development of our drugs and drug candidates. We do not assign our internal costs, such as salary and benefits, stock-based compensation expense, laboratory supplies and other direct expenses, and infrastructure costs, to individual drugs or drug candidates, because the employees within our research and development groups typically are deployed across multiple research and development programs. These internal costs are significantly greater than our external costs, such as the costs of services provided to us by clinical research organizations and other outsourced research, which we do allocate by individual program. All research and development costs for our drugs and drug candidates are expensed as incurred.

To date, we have incurred in excess of \$5.3 billion in research and development expenses associated with drug discovery and development. The successful development of our drug candidates is highly uncertain and subject to a number of risks. In addition, the duration of clinical trials may vary substantially according to the type, complexity and novelty of the drug candidate and the disease indication being targeted. The FDA and comparable agencies in foreign countries impose substantial requirements on the introduction of therapeutic pharmaceutical products, typically requiring lengthy and detailed laboratory and clinical testing procedures, sampling activities and other costly and time-consuming procedures. Data obtained from nonclinical and clinical activities at any step in the testing process may be adverse and lead to discontinuation or redirection of development activities. Data obtained from these activities also are susceptible to varying interpretations, which could delay, limit or prevent regulatory approval. The duration and cost of discovery, nonclinical studies and clinical trials may vary significantly over the life of a project and are difficult to predict. Therefore, accurate and meaningful estimates of the ultimate costs to bring our drug candidates to market are not available.

In recent periods, costs related to our HCV and CF programs have represented the largest portion of our development costs. We expect to continue to incur development costs related to the conduct of additional clinical trials to support potential supplemental applications for telaprevir and ivacaftor. We plan to evaluate a number of additional potential all-oral combination treatment regimens that could include VX-135, telaprevir, VX-222 and/or ribavirin in order to identify which all-oral combination treatment regimen or regimens to evaluate in Phase 3 clinical trials. Our drug candidates are still in early and mid-stage clinical development and, as a result, any estimates regarding development and regulatory timelines for these drug candidates are highly subjective and subject to change. We cannot make a meaningful estimate when, if ever, these drug candidates, including VX-135 and VX-222, will generate revenues and cash flows.

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	Three Months Ended September 30,		Increase/ (Decrease)	Increase/ (Decrease)	Nine Months Ended September 30,		Increase/ (Decrease)	Increase/ (Decrease)
	2012	2011	\$	%	2012	2011	\$	%
	(in thousands)				(in thousands)			
<b>Research Expenses:</b>								
Salary and benefits	\$ 18,714	\$ 21,016	\$ (2,302)	(11)%	\$ 57,536	\$ 56,766	\$ 770	1%
Stock-based compensation expense	6,268	6,841	(573)	(8)%	19,218	19,730	(512)	(3)%
Laboratory supplies and other direct expenses	8,730	8,932	(202)	(2)%	30,943	24,979	5,964	24%
Contractual services	5,304	3,236	2,068	64%	15,983	8,980	7,003	78%
Infrastructure costs	17,384	17,419	(35)	(0)%	52,208	50,093	2,115	4%
<b>Total research expenses</b>	<b>\$ 56,400</b>	<b>\$ 57,444</b>	<b>\$ (1,044)</b>	<b>(2)%</b>	<b>\$ 175,888</b>	<b>\$ 160,548</b>	<b>\$ 15,340</b>	<b>10%</b>

We have maintained a substantial investment in research activities, with a small decrease in research expenses in the third quarter of 2012 as compared to the third quarter of 2011 and a 10% increase in research expenses in the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011. Our research expenses include expenses incurred by Alios that are not reimbursable by us under our collaboration agreement with Alios. These research expenses incurred by Alios increased by \$0.1 million and \$6.8 million, respectively, in the three and nine months ended September 30, 2012 compared to the three and nine months ended September 30, 2011. We expect to continue to invest in our research programs in an effort to identify additional drug candidates.

*Development Expenses*

	Three Months Ended September 30,		Increase/ (Decrease)	Increase/ (Decrease)	Nine Months Ended September 30,		Increase/ (Decrease)	Increase/ (Decrease)
	2012	2011	\$	%	2012	2011	\$	%
	(in thousands)				(in thousands)			
<b>Development Expenses:</b>								
Salary and benefits	\$ 37,555	\$ 32,559	\$ 4,996	15%	\$ 106,700	\$ 93,847	\$ 12,853	14%
Stock-based compensation expense	11,176	11,811	(635)	(5)%	35,207	37,924	(2,717)	(7)%
Laboratory supplies and other direct expenses	7,953	9,405	(1,452)	(15)%	27,482	25,145	2,337	9%
Contractual services	58,500	37,939	20,561	54%	157,763	101,746	56,017	55%
Drug supply costs	1,705	14,623	(12,918)	(88)%	10,681	30,017	(19,336)	(64)%
Infrastructure costs	26,872	25,271	1,601	6%	79,355	72,041	7,314	10%
<b>Total development expenses</b>	<b>\$ 143,761</b>	<b>\$ 131,608</b>	<b>\$ 12,153</b>	<b>9%</b>	<b>\$ 417,188</b>	<b>\$ 360,720</b>	<b>\$ 56,468</b>	<b>16%</b>

Our development expenses increased by \$12.2 million, or 9%, in the third quarter of 2012 as compared to the third quarter of 2011, and by \$56.5 million, or 16%, in the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011, primarily as a result of increased contractual services expenses related to our ongoing and planned clinical trials to evaluate ivacaftor, VX-135, VX-787 and VX-809.



Table of Contents**Sales, General and Administrative Expenses**

	Three Months Ended September 30,		Increase/ (Decrease)	Increase/ (Decrease)	Nine Months Ended September 30,		Increase/ (Decrease)	Increase/ (Decrease)
	2012	2011	\$	%	2012	2011	\$	%

(in thousands)

(in thousands)

Sales, general and administrative expenses	\$ 97,684	\$ 110,654	\$ (12,970)	(12)%	\$ 326,344	\$ 278,840	\$ 47,504	17%
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Sales, general and administrative expenses decreased in the three months ended September 30, 2012 as compared to the three months ended September 30, 2011, primarily as a result of decreased sales and marketing expenses.

Sales, general and administrative expenses increased in the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011, primarily as a result of increases in workforce and commercial expenses associated with marketing INCIVEK and KALYDECO.

**Restructuring Expense (Credit)**

As of September 30, 2012, our lease restructuring liability was \$24.2 million. In the three months ended September 30, 2012 and 2011, we recorded restructuring expense (credit) of \$0.7 million and \$(0.4) million, respectively, and in the nine months ended September 30, 2012 and 2011, we recorded restructuring expense of \$1.7 million and \$1.1 million, respectively. In the three and nine months ended September 30, 2012, we made cash payments of \$3.7 million and \$11.1 million, respectively, against the accrued expense and received \$2.4 million and \$7.3 million, respectively, in sublease rental payments. During the fourth quarter of 2012, we expect to make additional cash payments of \$3.7 million against the accrued expense and to receive \$2.7 million in sublease rental payments.

**Intangible Asset Impairment Charge**

In the third quarter of 2011, we recorded an impairment charge of \$105.8 million related to VX-759, an HCV polymerase inhibitor that we acquired through our acquisition of ViroChem Pharma Inc. in 2009. VX-759 was a back-up to VX-222. In connection with this impairment charge, we recorded a benefit from income taxes of \$32.7 million resulting in a net effect on our income (loss) related to this impairment charge of \$73.1 million in the three and nine months ended September 30, 2011. There were no comparable charges in the three or nine months ended September 30, 2012.

**Non-operating Items****Interest Income**

Interest income increased by \$0.4 million to \$0.5 million for the third quarter of 2012 from \$0.1 million for the third quarter of 2011 and decreased by \$0.2 million to \$1.4 million for the nine months ended September 30, 2012 from \$1.7 million for the nine months ended September 30, 2011. Our cash, cash equivalents and marketable securities yielded less than 0.5% on an annual basis in the three and nine months ended September 30, 2012.

**Interest Expense**

Interest expense decreased by \$2.5 million to \$4.6 million in the third quarter of 2012 from \$7.1 million in the third quarter of 2011, and by \$13.2 million to \$12.9 million in the nine months ended September 30, 2012 from \$26.0 million in the nine months ended September 30, 2011. The decrease was the result of decreased interest expense related to our secured notes due 2012, which were redeemed in 2011. During the fourth quarter of 2012, we expect that we will incur approximately \$3 million in interest expense related to our convertible senior subordinated notes due 2015, or 2015 Notes.

Table of Contents**Change in Fair Value of Derivative Instruments**

In the three and nine months ended September 30, 2011, we recorded charges of \$8.1 million and \$15.9 million, respectively, in connection with the embedded and free-standing derivatives associated with our September 2009 financial transactions. In 2011, the contingent milestone payments that were the subject of the September 2009 financial transactions were earned in full. We did not incur any charges related to the September 2009 financial transactions in the nine months ended September 30, 2012 and will not incur any charges related to these financial transactions in future periods.

**Provision for (Benefit from) Income Taxes**

In the third quarter of 2012, we recorded a benefit from income taxes attributable to Vertex of \$39,000. In the nine months ended September 30, 2012, we recorded a provision for income taxes attributable to Vertex of \$1.1 million. These amounts reflect state tax planning implemented during the respective periods. In the three and nine months ended September 30, 2011, we recorded a benefit from income taxes attributable to Vertex of \$32.7 million related to the impairment of VX-759.

In the three and nine months ended September 30, 2012, we recorded a provision for income taxes attributable to noncontrolling interest (Alios) of \$21.4 million and \$40.4 million, respectively, primarily due to the changes in fair value of contingent milestone and royalty payments payable by us to Alios. In the three months ended September 30, 2011, we recorded a provision for income taxes attributable to noncontrolling interest (Alios) of \$4.9 million primarily due to the change in fair value of contingent milestone and royalty payments. In the nine months ended September 30, 2011, we recorded a provision for income taxes attributable to noncontrolling interest (Alios) of \$29.3 million primarily due to the estimated income tax effect on Alios of our \$60.0 million up-front payment to Alios in the second quarter of 2011. We have no liability for taxes payable by Alios, and the portion of the income tax provision related to Alios has been allocated to noncontrolling interest (Alios).

**Noncontrolling Interest (Alios)**

The net loss (income) attributable to noncontrolling interest (Alios) recorded on our condensed consolidated statements of operations reflects Alios' net loss (income) for the reporting period, as adjusted for changes during the reporting period in the fair value of the contingent milestone payments and royalties payable by us to Alios. The following table summarizes the net loss (income) attributable to noncontrolling interest (Alios) in the three and nine months ended September 30, 2012 and 2011:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
	<b>(in thousands)</b>			
Net income (loss)	\$ (26,467)	\$ 228,452	\$ 26,941	\$ (146,962)
Summary of net loss (income) attributable to noncontrolling interest (Alios):				
Operating costs and expenses	\$ 4,624	\$ 5,258	\$ 14,356	\$ 6,059
Other expense (income)	466		225	
Decrease (increase) in fair value of contingent milestone and royalty payments	(57,560)	(17,450)	(112,760)	(17,450)
Provision for income taxes	21,394	4,850	40,354	29,298
Net loss (income) attributable to noncontrolling interest (Alios)	\$ (31,076)	\$ (7,342)	\$ (57,825)	\$ 17,907
Net income (loss) attributable to Vertex	\$ (57,543)	\$ 221,110	\$ (30,884)	\$ (129,055)

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In the three and nine months ended September 30, 2012, the fair value of contingent milestone payments and royalties payable by us to Alios increased by \$57.6 million and \$112.8 million, respectively, as a result of the positive data from a Phase 1 clinical trial evaluating VX-135. In both the three and nine months ended September 30, 2011, the fair value of contingent milestone payments and royalties payable by us to Alios increased by \$17.5 million as a result of the advancement of VX-135 and ALS-2158 in the third quarter of 2011.

Increases in the fair value of the contingent milestone payments and royalties payable by us to Alios result in a decrease in net income attributable to Vertex (or an increase in net loss attributable to Vertex) on a dollar-for-dollar basis. If VX-135 continues to advance in clinical development, we expect to record additional increases in the fair value of these contingent milestone and royalty payments. Changes in the fair value of these contingent milestone and royalty payments and the effects of these changes on net income (loss) attributable to Vertex were material in the three and nine months ended September 30, 2012 and 2011 and may be material in future periods.

**LIQUIDITY AND CAPITAL RESOURCES**

As of September 30, 2012, we had cash, cash equivalents and marketable securities, excluding Alios' cash and cash equivalents, of \$1.3 billion, which was an increase of \$329.6 million from \$968.9 million as of December 31, 2011. This increase principally was due to cash receipts from product and royalty revenues and approximately \$175 million from issuances of common stock from employee benefit plans in the nine months ended September 30, 2012, partially offset by cash expenditures we made in the nine months ended September 30, 2012 related to, among other things, research and development expenses, sales, general and administrative expenses and milestone payments to Alios.

*Sources of Liquidity*

We intend to rely on cash flows from product sales as our primary source of liquidity and cash flows from royalties as a secondary source of liquidity. We also generate proceeds from the issuance of common stock under our employee benefit plans. Other possible sources of liquidity include commercial debt, public and private offerings of our equity and debt securities, strategic collaborative agreements that include research and/or development funding, development milestones and royalties on the sales of products, strategic sales of assets or businesses and financial transactions. Our credit facility expired in July 2012.

*Future Capital Requirements*

We are incurring substantial expenses to commercialize INCIVEK and KALYDECO, while at the same time continuing to pursue diversified research and development efforts for our drugs and drug candidates. We may in the future require capital to repay the \$400.0 million in aggregate principal amount of 2015 Notes. The 2015 Notes bear interest at the rate of 3.35% per annum, and we are required to make semi-annual interest payments on the outstanding principal balance of the 2015 Notes on April 1 and October 1 of each year. The 2015 Notes will mature on October 1, 2015 and are convertible, at the option of the holder, into our common stock at a price equal to approximately \$48.83 per share, subject to adjustment, and can be called by us at any time on or after October 1, 2013. In addition, we have substantial lease obligations that will continue through 2028.

We expect that our cash flows from INCIVEK/INCIVO and KALYDECO together with our current cash, cash equivalents and marketable securities will be sufficient to fund our operations for at least the next twelve months. The adequacy of our available funds to meet our future operating and capital requirements will depend on many factors, including the amounts of future revenues generated by INCIVEK/INCIVO and KALYDECO, and the number, breadth, cost and prospects of our discovery and development programs.

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*Financing Strategy*

Although we do not have any plans to do so in the near term, we may raise additional capital through public offerings or private placements of our securities, securing new collaborative agreements or other methods of financing. As part of our strategy for managing our capital structure, we have from time to time adjusted the amount and maturity of our debt obligations through new issues, privately negotiated transactions and market purchases, depending on market conditions and our perceived needs at the time. We expect to continue pursuing a general financial strategy that may lead us to undertake one or more additional transactions with respect to our outstanding debt obligations, and the amounts involved in any such transactions, individually or in the aggregate, may be material. We will continue to manage our capital structure and to consider all financing opportunities, whenever they may occur, that could strengthen our long-term liquidity profile. Any capital transaction related to our outstanding debt obligations may or may not be similar to transactions in which we have engaged in the past. There can be no assurance that any such financing opportunities will be available on acceptable terms, if at all.

**CONTRACTUAL COMMITMENTS AND OBLIGATIONS**

Our commitments and obligations were reported in our Annual Report on Form 10-K for the year ended December 31, 2011, which was filed with the Securities and Exchange Commission, or SEC, on February 22, 2012. There have been no material changes from the contractual commitments and obligations previously disclosed in that Annual Report on Form 10-K.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Our discussion and analysis of our financial condition and results of operations is based upon our condensed consolidated financial statements prepared in accordance with generally accepted accounting principles in the United States. The preparation of these financial statements requires us to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reported periods. These items are monitored and analyzed by management for changes in facts and circumstances, and material changes in these estimates could occur in the future. Changes in estimates are reflected in reported results for the period in which the change occurs. We base our estimates on historical experience and various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from our estimates if past experience or other assumptions do not turn out to be substantially accurate. During the three months ended September 30, 2012, there were no material changes to our critical accounting policies as reported in our Annual Report on Form 10-K for the year ended December 31, 2011, which was filed with the SEC on February 22, 2012.

**RECENT ACCOUNTING PRONOUNCEMENTS**

Refer to Note A, "Basis of Presentation and Accounting Policies Recent Accounting Pronouncements," in the accompanying notes to the condensed consolidated financial statements. In the first quarter of 2012, we retrospectively adopted amended guidance issued in June 2011 by the Financial Accounting Standards Board that resulted in two separate, but consecutive, statements of operations and comprehensive income (loss) that affected the presentation of our condensed consolidated financial statements. There were no new accounting pronouncements adopted during the three months ended September 30, 2012 that had a material effect on our financial statements.

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

As part of our investment portfolio, we own financial instruments that are sensitive to market risk. The investment portfolio is used to preserve our capital until it is required to fund operations, including our research and development activities. None of these market risk-sensitive instruments are held for trading purposes. We do not have derivative financial instruments in our investment portfolio.

**Interest Rate Risk**

We invest our cash in a variety of financial instruments, principally securities issued by the U.S. government and its agencies, investment grade corporate bonds and commercial paper, and money market funds. These investments are denominated in U.S. dollars. All of our interest-bearing securities are subject to interest rate risk, and could decline in value if interest rates fluctuate. Substantially all of our investment portfolio consists of marketable securities with active secondary or resale markets to help ensure portfolio liquidity, and we have implemented guidelines limiting the term-to-maturity of our investment instruments. Due to the conservative nature of these instruments, we do not believe that we have a material exposure to interest rate risk.

**Foreign Exchange Market Risk**

As a result of our foreign operations, we face exposure to movements in foreign currency exchange rates, primarily the Euro, Swiss Franc, British Pound and Canadian Dollar against the U.S. dollar. The current exposures arise primarily from cash, accounts receivable, intercompany receivables and payables, and calculations of royalties receivable from net sales denominated in foreign currencies. Both positive and negative impacts to our international product sales from movements in foreign currency exchange rates are partially mitigated by the natural, opposite impact that foreign currency exchange rates have on our international operating expenses.

We are considering a foreign currency management program with the objective of reducing the volatility of exchange rate fluctuations on our operating results and to increase the predictability of the foreign exchange impact on forecasted revenues and expenses.

**Item 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

Our chief executive officer and chief financial officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this Quarterly Report on Form 10-Q, have concluded that, based on such evaluation, as of September 30, 2012 our disclosure controls and procedures were effective and designed to provide reasonable assurance that the information required to be disclosed is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. In designing and evaluating our disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

**Changes in Internal Controls Over Financial Reporting**

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended) occurred during the three months ended September 30, 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**Part II. Other Information**

**Item 1. Legal Proceedings**

On September 6, 2012, a purported shareholder class action, *City of Bristol Pension Fund v. Vertex Pharmaceuticals Incorporated, et al.*, was filed in the United States District Court for the District of Massachusetts, naming us and certain of our officers and directors as defendants. The lawsuit alleges that we made material misrepresentations and/or omissions of material fact in our public disclosures during the period from May 7, 2012 through June 28, 2012, all in violation of Section 10(b) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder. The plaintiffs seek unspecified damages on behalf of the putative class, unspecified injunctive relief and an award of costs and expenses, including attorney's fees. We believe that this action is without merit, and intend to defend it vigorously.

**Item 1A. Risk Factors**

Information regarding risk factors appears in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2011, which was filed with the SEC on February 22, 2012 as supplemented by Item 1A of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2012, which was filed with the SEC on May 10, 2012 and Item 1A of our Quarterly Report for the quarter ended June 30, 2012, which was filed with the SEC on August 8, 2012. There have been no material changes from the risk factors previously disclosed in that Annual Report on Form 10-K as supplemented by our Quarterly Reports on Form 10-Q for the quarters ended March 31, 2012 and June 30, 2012 except:

*We could be negatively affected by securities class action complaints.*

On September 6, 2012, a purported securities class action lawsuit was commenced in the United States District Court for the District of Massachusetts under the caption *City of Bristol Pension Fund v. Vertex Pharmaceuticals Incorporated, et al.*, naming as defendants us and certain of our officers and directors. The lawsuit alleges that we made material misrepresentations and/or omissions of material fact in our public disclosures during the period from May 7, 2012 through June 28, 2012, all in violation of Section 10(b) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder. The plaintiffs seek unspecified damages on behalf of the putative class, unspecified injunctive relief and an award of costs and expenses, including attorney's fees. We believe that this action is without merit and intend to defend it vigorously. This action will take time and money to defend and may distract us from more productive activities. No assurance can be provided that we will be successful in defending this claim or that insurance proceeds will be sufficient to cover any liability under such claims.

**SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q and, in particular, our Management's Discussion and Analysis of Financial Condition and Results of Operations set forth in Part I Item 2, contain or incorporate a number of forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including statements regarding:

expectations regarding the amount of, timing of and trends with respect to our revenues, costs and expenses and other gains and losses, including those related to product revenues from sales of INCIVEK and KALYDECO and royalty revenues from sales of INCIVO and to the intangible assets associated with the ViroChem acquisition and the Alios collaboration;

our expectations regarding development timelines and regulatory authority filings and submissions for telaprevir, VX-222, VX-135, ivacaftor, VX-809, VX-661, VX-509 and VX-787;

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our plan to initiate a pivotal program to evaluate VX-809 in combination with ivacaftor and our plans to initiate clinical trials of VX-135 (including in combination with GSK2336805, TMC435, ribavirin and telaprevir).

our ability to successfully market INCIVEK and/or KALYDECO or any of our drug candidates if we obtain regulatory approval;

our expectations regarding the timing and structure of clinical trials of our drugs and drug candidates, including telaprevir, ivacaftor, VX-222, VX-135, VX-809, VX-661, VX-509 and VX-787, and the expected timing of our receipt of data from our and our collaborators' ongoing and planned clinical trials;

the data that will be generated by ongoing and planned clinical trials and the ability to use that data to support regulatory filings, as well as the expected timing of such regulatory filings and resulting potential approvals;

our beliefs regarding the support provided by clinical trials and preclinical and nonclinical studies of our drug candidates for further investigation, clinical trials or potential use as a treatment;

the focus of our drug development efforts and our financial and management resources and our plan to continue investing in our diversified research and development programs and to develop and commercialize selected drug candidates that emerge from those programs, alone or with third-party collaborators;

the establishment, development and maintenance of collaborative relationships;

potential business development activities;

our ability to use our research programs to identify and develop new drug candidates to address serious diseases and significant unmet medical needs;

our estimates regarding obligations associated with a lease of a facility in Kendall Square, Cambridge, Massachusetts; and

our liquidity and our expectations regarding the possibility of raising additional capital.

Without limiting the foregoing, the words "believes," "anticipates," "plans," "intends," "expects" and similar expressions are intended to identify forward-looking statements. Any or all of our forward-looking statements in this Quarterly Report on Form 10-Q may turn out to be wrong. They can be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties. Many factors mentioned in our discussion in this Quarterly Report on Form 10-Q will be important in determining future results. Consequently, no forward-looking statement can be guaranteed. Actual future results may vary materially from expected results. We also provide a cautionary discussion of risks and uncertainties under "Risk Factors" in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2011, which was filed with the SEC on February 22, 2012, and updated and supplemented by "Part II Item 1A Risk Factors" of our Quarterly Reports on Form 10-Q for the quarters ended March 31, 2012 and June 30, 2012 and this Quarterly Report on Form 10-Q. These are factors that we think could cause our actual results to differ materially from expected results. Other factors besides those listed could also adversely affect us. In addition, the forward-looking statements contained herein represent our estimate only as of the date of this filing and should not be relied upon as representing our estimate as of any subsequent date. While we may elect to update these forward-looking statements at some point in the future, we specifically disclaim any obligation to do so to reflect actual results, changes in assumptions or changes in other factors affecting such forward-looking statements.





Table of Contents**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds****Issuer Repurchases of Equity Securities**

The table set forth below shows all repurchases of securities by us during the three months ended September 30, 2012:

<b>Period</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</b>	<b>Maximum Number of Shares That May Yet be Purchased under Publicly Announced Plans or Programs</b>
July 1, 2012 to July 31, 2012	13,407	\$ 0.01		
August 1, 2012 to August 31, 2012	20,433	\$ 0.01		
September 1, 2012 to September 30, 2012	23,807	\$ 0.01		

The repurchases were made under the terms of our Amended and Restated 2006 Stock and Option Plan. Under this plan, we award shares of restricted stock to our employees that typically are subject to a lapsing right of repurchase by us. We may exercise this right of repurchase if a restricted stock recipient's service to us is terminated. If we exercise this right, we are required to repay the purchase price paid by or on behalf of the recipient for the repurchased restricted shares, which typically is the par value per share of \$0.01. Repurchased shares are returned to the Amended and Restated 2006 Stock and Option Plan and are available for future awards under the terms of that plan.

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**Item 6. Exhibits**

<b>Exhibit No.</b>	<b>Description</b>
10.1	Employment Agreement, dated as of August 27, 2012, between Vertex Pharmaceuticals Incorporated and Stuart Arbuckle.*
10.2	Change of Control Agreement, dated as of August 27, 2012, between Vertex Pharmaceuticals Incorporated and Stuart Arbuckle.*
10.3	Employment Agreement, dated as of July 25, 2012, between Vertex Pharmaceuticals Incorporated and Megan Pace.*
10.4	Second Amended and Restated Change of Control Agreement, dated as of July 25, 2012, between Vertex Pharmaceuticals Incorporated and Megan Pace.*
31.1	Certification of the Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer under Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of the Chief Executive Officer and Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	XBRL Instance
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation
101.LAB	XBRL Taxonomy Extension Labels
101.PRE	XBRL Taxonomy Extension Presentation
101.DEF	XBRL Taxonomy Extension Definition

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\* Management contract, compensatory plan or agreement.

