Merck & Co. Inc.
Form 10-Q
August 07, 2013

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2013

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 No. 1-6571
Merck & Co., Inc.
One Merck Drive
Whitehouse Station, N.J. 08889-0100
(908) 423-1000

Incorporated in New Jersey	I.R.S. Employer Identification No. 22-1918501

The number of shares of common stock outstanding as of the close of business on July 31, 2013: 2,926,375,532

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 x No ¨

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

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

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

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

Part I - Financial Information
Item 1. Financial Statements
MERCK & CO., INC. AND SUBSIDIARIES
INTERIM CONSOLIDATED STATEMENT OF INCOME
(Unaudited, $ in millions except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Sales	$11,010	$12,311	$21,681	$24,041
Costs, Expenses and Other				
Materials and production	4,284	4,112	8,243	8,150
Marketing and administrative	3,140	3,249	6,126	6,322
Research and development	2,101	2,165	4,008	4,026
Restructuring costs	155	144	274	363
Equity income from affiliates	(116)	(142)	(249)	(253)
Other (income) expense, net	201	103	484	247
	9,765	9,631	18,886	18,855
Income Before Taxes	1,245	2,680	2,795	5,186
Taxes on Income	310	860	244	1,599
Net Income	$935	$1,820	$2,551	$3,587
Less: Net Income Attributable to Noncontrolling Interests	29	27	52	56
Net Income Attributable to Merck & Co., Inc.	$906	$1,793	$2,499	$3,531
Basic Earnings per Common Share Attributable to Merck & Co., Inc. Common Shareholders	$0.30	$0.59	$0.83	$1.16
Earnings per Common Share Assuming Dilution Attributable to Merck & Co., Inc. Common Shareholders	$0.30	$0.58	$0.82	$1.15
Dividends Declared per Common Share	$0.43	$0.42	$0.86	$0.84

MERCK & CO., INC. AND SUBSIDIARIES
INTERIM CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
(Unaudited, $ in millions)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net Income Attributable to Merck & Co., Inc.	$906	$1,793	$2,499	$3,531
Other Comprehensive Income (Loss) Net of Taxes:				
Net unrealized gain on derivatives, net of reclassifications	35	102	271	44
Net unrealized (loss) gain on investments, net of reclassifications	(81)	1	(80)	30
Benefit plan net gain and prior service cost, net of amortization	51	18	212	18
Cumulative translation adjustment	(136)	(30)	(481)	(86)
	(131)	91	(78)	6
Comprehensive Income Attributable to Merck & Co., Inc.	$775	$1,884	$2,421	$3,537

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

MERCK & CO., INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET
(Unaudited, $ in millions except per share amounts)

	June 30, 2013	December 31, 2012
Assets		
Current Assets		
Cash and cash equivalents	$15,090	$13,451
Short-term investments	3,008	2,690
Accounts receivable (net of allowance for doubtful accounts of $137 in 2013 and $163 in 2012) (excludes accounts receivable of $490 in 2013 and $473 in 2012 classified in Other assets - see Note 4)	7,779	7,672
Inventories (excludes inventories of $1,515 in 2013 and $1,606 in 2012 classified in Other assets - see Note 5)	6,766	6,535
Deferred income taxes and other current assets	4,352	4,509
Total current assets	36,995	34,857
Investments	8,555	7,305
Property, Plant and Equipment, at cost, net of accumulated depreciation of $17,594 in 2013 and $17,385 in 2012	15,683	16,030
Goodwill	12,198	12,134
Other Intangibles, Net	26,333	29,083
Other Assets	7,112	6,723
	$106,876	$106,132
Liabilities and Equity		
Current Liabilities		
Loans payable and current portion of long-term debt	$5,582	$4,315
Trade accounts payable	2,253	1,753
Accrued and other current liabilities	8,872	9,737
Income taxes payable	409	1,200
Dividends payable	1,286	1,343
Total current liabilities	18,402	18,348
Long-Term Debt	22,526	16,254
Deferred Income Taxes and Noncurrent Liabilities	15,843	16,067
Merck & Co., Inc. Stockholders' Equity		
Common stock, $0.50 par value		
Authorized - 6,500,000,000 shares	1,788	1,788
Issued - 3,577,103,522 shares in 2013 and 2012		
Other paid-in capital	39,891	40,646
Retained earnings	39,915	39,985
Accumulated other comprehensive loss	(4,760)	(4,682)
	76,834	77,737
Less treasury stock, at cost: 650,630,672 shares in 2013 and 550,468,221 shares in 2012	29,334	24,717
Total Merck & Co., Inc. stockholders' equity	47,500	53,020
Noncontrolling Interests	2,605	2,443
Total equity	50,105	55,463
	$106,876	$106,132

The accompanying notes are an integral part of this consolidated financial statement.

MERCK & CO., INC. AND SUBSIDIARIES
INTERIM CONSOLIDATED STATEMENT OF CASH FLOWS
(Unaudited, $ in millions)

	Six Months Ended June 30,	
	2013	2012
Cash Flows from Operating Activities		
Net income	$2,551	$3,587
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,329	3,594
Intangible asset impairment charges	594	136
Equity income from affiliates	(249)	(253)
Dividends and distributions from equity affiliates	68	122
Deferred income taxes	(319)	(365)
Share-based compensation	142	169
Other	372	143
Net changes in assets and liabilities	(1,809)	(2,059)
Net Cash Provided by Operating Activities	4,679	5,074
Cash Flows from Investing Activities		
Capital expenditures	(764)	(762)
Purchases of securities and other investments	(8,818)	(4,001)
Proceeds from sales of securities and other investments	7,195	4,174
Other	99	21
Net Cash Used in Investing Activities	(2,288)	(568)
Cash Flows from Financing Activities		
Net change in short-term borrowings	1,702	1,637
Proceeds from issuance of debt	6,467	—
Payments on debt	(515)	(2)
Purchases of treasury stock	(6,105)	(985)
Dividends paid to stockholders	(2,638)	(2,559)
Proceeds from exercise of stock options	641	601
Other	(3)	(3)
Net Cash Used in Financing Activities	(451)	(1,311)
Effect of Exchange Rate Changes on Cash and Cash Equivalents	(301)	26
Net Increase in Cash and Cash Equivalents	1,639	3,221
Cash and Cash Equivalents at Beginning of Year	13,451	13,531
Cash and Cash Equivalents at End of Period	$15,090	$16,752

The accompanying notes are an integral part of this consolidated financial statement.

Notes to Interim Consolidated Financial Statements (unaudited)

1. Basis of Presentation

The accompanying unaudited interim consolidated financial statements of Merck & Co., Inc. ("Merck" or the "Company") have been prepared pursuant to the rules and regulations for reporting on Form 10-Q. Accordingly, certain information and disclosures required by accounting principles generally accepted in the United States for complete consolidated financial statements are not included herein. These interim statements should be read in conjunction with the audited financial statements and notes thereto included in Merck's Form 10-K filed on February 28, 2013.

The results of operations of any interim period are not necessarily indicative of the results of operations for the full year. In the Company's opinion, all adjustments necessary for a fair presentation of these interim statements have been included and are of a normal and recurring nature.

Recently Adopted Accounting Standards

In the first quarter of 2013, the Company adopted guidance issued by the Financial Accounting Standards Board (the "FASB") that simplifies how an entity tests indefinite-lived intangibles for impairment. The amended guidance allows companies to first assess qualitative factors to determine whether it is more-likely-than-not that an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform the quantitative impairment test. The adoption of this guidance had no impact on the Company's financial position and results of operations.

2. Restructuring

Merger Restructuring Program

In 2010, subsequent to the Merck and Schering-Plough Corporation ("Schering-Plough") merger (the "Merger"), the Company commenced actions under a global restructuring program (the "Merger Restructuring Program") in conjunction with the integration of the legacy Merck and legacy Schering-Plough businesses designed to optimize the cost structure of the combined company. These initial actions, which are expected to result in workforce reductions of approximately 17%, primarily reflect the elimination of positions in sales, administrative and headquarters organizations, as well as from the sale or closure of certain manufacturing and research and development sites and the consolidation of office facilities. In July 2011, the Company initiated further actions under the Merger Restructuring Program through which the Company expects to reduce its workforce measured at the time of the Merger by an additional 12% to 13% across the Company worldwide. A majority of the workforce reductions associated with these additional actions relate to manufacturing (including Animal Health), administrative and headquarters organizations. The Company will continue to hire employees in strategic growth areas of the business as necessary.

The Company recorded total pretax restructuring costs of $265 million and $293 million in the second quarter of 2013 and 2012, respectively, and $418 million and $572 million in the first six months of 2013 and 2012, respectively, related to this program. Since inception of the Merger Restructuring Program through June 30, 2013, Merck has recorded total pretax accumulated costs of approximately $6.5 billion and eliminated approximately 23,810 positions comprised of employee separations, as well as the elimination of contractors and vacant positions. The restructuring actions under the Merger Restructuring Program are expected to be substantially completed by the end of 2013, with the exception of certain actions, principally manufacturing-related. Subsequent to the Merger, the Company has rationalized a number of manufacturing sites worldwide. The remaining actions under this program will result in additional manufacturing facility rationalizations, which are expected to be substantially completed by 2016. The Company expects the estimated total cumulative pretax costs for this program to be approximately $7.2 billion to $7.5 billion. The Company estimates that approximately two-thirds of the cumulative pretax costs relate to cash outlays, primarily related to employee separation expense. Approximately one-third of the cumulative pretax costs are non-cash, relating primarily to the accelerated depreciation of facilities to be closed or divested.

2008 Global Restructuring Program

In October 2008, Merck announced a global restructuring program (the "2008 Restructuring Program") to reduce its cost structure, increase efficiency, and enhance competitiveness. As part of the 2008 Restructuring Program, the Company expects to eliminate approximately 7,200 positions — 6,800 active employees and 400 vacancies — across the Company worldwide. Pretax restructuring costs of $13 million and $(4) million were recorded in the second quarter of 2013 and 2012, respectively, and $54 million and $10 million were recorded in the first six months of 2013 and 2012,

respectively, related to the 2008 Restructuring Program. Since inception of the 2008 Restructuring Program through June 30, 2013, Merck has recorded total pretax accumulated costs of approximately $1.7 billion and eliminated approximately 6,460 positions comprised of employee separations and the elimination of contractors and vacant positions. The 2008 Restructuring Program was substantially completed in 2011, with the exception of certain manufacturing-related actions, which are expected to be completed by the end of 2015, with the total cumulative pretax costs estimated to be up to $2.0 billion. The Company estimates that two-thirds of the cumulative pretax costs relate to cash outlays, primarily from employee separation expense. Approximately one-third of the cumulative pretax costs are non-cash, relating primarily to the accelerated depreciation of facilities to be closed or divested.

Notes to Interim Consolidated Financial Statements (unaudited) (continued)

For segment reporting, restructuring charges are unallocated expenses.

The following tables summarize the charges related to Merger Restructuring Program and 2008 Restructuring Program activities by type of cost:

	Three Months Ended June 30, 2013				Six Months Ended June 30, 2013			
($ in millions)	Separation Costs	Accelerated Depreciation	Other	Total	Separation Costs	Accelerated Depreciation	Other	Total
Merger Restructuring Program								
Materials and production	$—	$ 30	$62	$92	$—	$ 61	$71	$132
Marketing and administrative	—	9	5	14	—	24	5	29
Research and development	—	14	—	14	—	29	—	29
Restructuring costs	129	—	16	145	194	—	34	228
	129	53	83	265	194	114	110	418
2008 Restructuring Program								
Materials and production	—	(2)	3	1	—	(2)	6	4
Marketing and administrative	—	2	—	2	—	4	—	4
Restructuring costs	2	—	8	10	34	—	12	46
	2	—	11	13	34	2	18	54
	$131	$ 53	$94	$278	$228	$ 116	$128	$472

	Three Months Ended June 30, 2012				Six Months Ended June 30, 2012			
($ in millions)	Separation Costs	Accelerated Depreciation	Other	Total	Separation Costs	Accelerated Depreciation	Other	Total
Merger Restructuring Program								
Materials and production	$—	$ 58	$20	$78	$—	$ 37	$37	$74
Marketing and administrative	—	20	1	21	—	43	2	45
Research and development	—	41	—	41	—	82	4	86
Restructuring costs	124	—	29	153	304	—	63	367
	124	119	50	293	304	162	106	572
2008 Restructuring Program								
Materials and production	—	1	4	5	—	3	11	14
Restructuring costs	(13)	—	4	(9)	(11)	—	7	(4)
	(13)	1	8	(4)	(11)	3	18	10
	$111	$ 120	$58	$289	$293	$ 165	$124	$582

Separation costs are associated with actual headcount reductions, as well as those headcount reductions which were probable and could be reasonably estimated. In the second quarter of 2013 and 2012, approximately 670 positions and 780 positions, respectively, were eliminated under the Merger Restructuring Program. In addition, approximately 10 positions were eliminated in the second quarter of 2013 under the 2008 Restructuring Program. In the first six months

of 2013 and 2012, approximately 1,405 positions and 1,800 positions, respectively, were eliminated under the Merger Restructuring Program and approximately 55 positions and 140 positions, respectively, were eliminated under the 2008 Restructuring Program.These position eliminations were comprised of actual headcount reductions and the elimination of contractors and vacant positions.

Accelerated depreciation costs primarily relate to manufacturing, research and administrative facilities and equipment to be sold or closed as part of the programs. Accelerated depreciation costs represent the difference between the depreciation expense to be recognized over the revised useful life of the site, based upon the anticipated date the site will be closed or divested, and depreciation expense as determined utilizing the useful life prior to the restructuring actions. All of the sites have and will continue to operate up through the respective closure dates and, since future cash flows were sufficient to recover the respective book values, Merck was required to accelerate depreciation of the site assets rather than write them off immediately. Anticipated site closure dates, particularly related to manufacturing locations, have been and may continue to be adjusted to reflect changes resulting from regulatory or other factors.

Other activity in 2013 and 2012 includes asset abandonment, shut-down and other related costs. Additionally, other activity includes employee-related costs such as curtailment, settlement and termination charges associated with pension and other postretirement benefit plans (see Note 12) and share-based compensation costs.

Adjustments to the recorded amounts were not material in any period.

Notes to Interim Consolidated Financial Statements (unaudited) (continued)

The following table summarizes the charges and spending relating to Merger Restructuring Program and 2008 Restructuring Program activities for the six months ended June 30, 2013:

($ in millions)	Separation Costs	Accelerated Depreciation	Other	Total
Merger Restructuring Program				
Restructuring reserves January 1, 2013	$699	$—	$19	$718
Expense	194	114	110	418
(Payments) receipts, net	(227)	—	(56)	(283)
Non-cash activity	—	(114)	(67)	(181)
Restructuring reserves June 30, 2013 [1]	$666	$—	$6	$672
2008 Restructuring Program				
Restructuring reserves January 1, 2013	$77	$—	$—	$77
Expense	34	2	18	54
(Payments) receipts, net	(49)	—	(11)	(60)
Non-cash activity	—	(2)	(7)	(9)
Restructuring reserves June 30, 2013 [1]	$62	$—	$—	$62

(1) The cash outlays associated with the Merger Restructuring Program are expected to be substantially completed by the end of 2013 with the exception of certain actions, principally manufacturing-related, which are expected to be substantially completed by 2016. The cash outlays associated with the remaining restructuring reserves for the 2008 Restructuring Program are primarily manufacturing-related and are expected to be completed by the end of 2015.

3. Acquisitions, Research Collaborations and License Agreements

The Company continues its strategy of establishing external alliances to complement its substantial internal research capabilities, including research collaborations, licensing preclinical and clinical compounds and technology platforms to drive both near- and long-term growth. The Company supplements its internal research with a licensing and external alliance strategy focused on the entire spectrum of collaborations from early research to late-stage compounds, as well as new technologies across a broad range of therapeutic areas. These arrangements often include upfront payments and royalty or profit share payments, contingent upon the occurrence of certain future events linked to the success of the asset in development, as well as expense reimbursements or payments to the third party.

In April 2013, Merck and Pfizer Inc. (“Pfizer”) announced that they had entered into a worldwide (except Japan) collaboration agreement for the development and commercialization of Pfizer’s ertugliflozin, an investigational oral sodium glucose cotransporter (“SGLT2”) inhibitor being evaluated for the treatment of type 2 diabetes. Ertugliflozin is Phase III ready, with trials expected to begin later in 2013. Under the terms of the agreement, Merck and Pfizer will collaborate on the clinical development and commercialization of ertugliflozin and ertugliflozin-containing fixed-dose combinations with metformin and Januvia (sitagliptin) tablets. Merck will continue to retain the rights to its existing portfolio of sitagliptin-containing products. Through the first quarter of 2013, Merck recorded as Research and development expenses $60 million of upfront and milestone payments made to Pfizer. Pfizer will be eligible for additional payments associated with the achievement of pre-specified future clinical, regulatory and commercial milestones. The companies will share potential revenues and certain costs 60% to Merck and 40% to Pfizer. Each party will have certain manufacturing and supply obligations. The Company has the right to terminate the agreement at any time up to the commencement of the first Phase III clinical trial. The Company and Pfizer each have the right to terminate the agreement due to a material, uncured breach by, or insolvency of, the other party, or in the event of a safety issue. Pfizer has the right to terminate the agreement upon 12 months notice at any time following the first anniversary of the first commercial sale of a collaboration product, but must assign all rights to ertugliflozin to Merck. Upon termination of the agreement, depending upon the circumstances, the parties have varying rights and obligations with respect to the continued development and commercialization of ertugliflozin and certain payment obligations.

In February 2013, Merck and Supera Farma Laboratorios S.A. (“Supera”), a Brazilian pharmaceutical company co-owned by Cristália and Eurofarma, established the previously announced joint venture that markets, distributes and sells a portfolio of innovative pharmaceutical and branded generic products from Merck, Cristália and Eurofarma in Brazil. Merck owns 51% of the joint venture, and Cristália and Eurofarma collectively own 49%. The transaction was accounted for as an acquisition of a business; accordingly, the assets acquired and liabilities assumed were recorded at their respective fair values. This resulted in Merck recognizing intangible assets for currently marketed products of $89 million, in-process research and development (“IPR&D”) of $100 million, goodwill of $103 million, and deferred tax liabilities of $64 million. The Company also recorded increases to Noncontrolling interests and Other paid-in capital in the amounts of $112 million and $116 million, respectively. This transaction

Notes to Interim Consolidated Financial Statements (unaudited) (continued)

closed on February 1, 2013, and accordingly, the results of operations of the acquired business have been included in the Company's results of operations beginning after that date.

Remicade/Simponi

In 1998, a subsidiary of Schering-Plough entered into a licensing agreement with Centocor Ortho Biotech Inc. ("Centocor"), a Johnson & Johnson ("J&J") company, to market Remicade, which is prescribed for the treatment of inflammatory diseases. In 2005, Schering-Plough's subsidiary exercised an option under its contract with Centocor for license rights to develop and commercialize Simponi, a fully human monoclonal antibody. The Company has exclusive marketing rights to both products throughout Europe, Russia and Turkey. All profits derived from Merck's exclusive distribution of the two products in these countries are equally divided between Merck and J&J. In December 2007, Schering-Plough and Centocor revised their distribution agreement regarding the development, commercialization and distribution of both Remicade and Simponi, extending the Company's rights to exclusively market Remicade to match the duration of the Company's exclusive marketing rights for Simponi. In addition, Schering-Plough and Centocor agreed to share certain development costs relating to Simponi's auto-injector delivery system. On October 6, 2009, the European Commission approved Simponi as a treatment for rheumatoid arthritis and other immune system disorders in two presentations – a novel auto-injector and a prefilled syringe. As a result, the Company's marketing rights for both products extend for 15 years from the first commercial sale of Simponi in the European Union (the "EU") following the receipt of pricing and reimbursement approval within the EU.

4. Financial Instruments

Derivative Instruments and Hedging Activities

The Company manages the impact of foreign exchange rate movements and interest rate movements on its earnings, cash flows and fair values of assets and liabilities through operational means and through the use of various financial instruments, including derivative instruments.

A significant portion of the Company's revenues and earnings in foreign affiliates is exposed to changes in foreign exchange rates. The objectives and accounting related to the Company's foreign currency risk management program, as well as its interest rate risk management activities are discussed below.

Foreign Currency Risk Management

The Company has established revenue hedging, balance sheet risk management and net investment hedging programs to protect against volatility of future foreign currency cash flows and changes in fair value caused by volatility in foreign exchange rates.

The objective of the revenue hedging program is to reduce the potential for longer-term unfavorable changes in foreign exchange rates to decrease the U.S. dollar value of future cash flows derived from foreign currency denominated sales, primarily the euro and Japanese yen. To achieve this objective, the Company will hedge a portion of its forecasted foreign currency denominated third-party and intercompany distributor entity sales that are expected to occur over its planning cycle, typically no more than 3 years into the future. The Company will layer in hedges over time, increasing the portion of third-party and intercompany distributor entity sales hedged as it gets closer to the expected date of the forecasted foreign currency denominated sales. The portion of sales hedged is based on assessments of cost-benefit profiles that consider natural offsetting exposures, revenue and exchange rate volatilities and correlations, and the cost of hedging instruments. The hedged anticipated sales are a specified component of a portfolio of similarly denominated foreign currency-based sales transactions, each of which responds to the hedged currency risk in the same manner. The Company manages its anticipated transaction exposure principally with purchased local currency put options, which provide the Company with a right, but not an obligation, to sell foreign currencies in the future at a predetermined price. If the U.S. dollar strengthens relative to the currency of the hedged anticipated sales, total changes in the options' cash flows offset the decline in the expected future U.S. dollar equivalent cash flows of the hedged foreign currency sales. Conversely, if the U.S. dollar weakens, the options' value reduces to zero, but the Company benefits from the increase in the U.S. dollar equivalent value of the anticipated foreign currency cash flows.

In connection with the Company's revenue hedging program, a purchased collar option strategy may be utilized. With a purchased collar option strategy, the Company writes a local currency call option and purchases a local currency put option. As compared to a purchased put option strategy alone, a purchased collar strategy reduces the upfront costs associated with purchasing puts through the collection of premium by writing call options. If the U.S. dollar weakens relative to the currency of the hedged anticipated sales, the purchased put option value of the collar strategy reduces to zero and the Company benefits from the increase in the U.S. dollar equivalent value of its anticipated foreign currency cash flows, however this benefit would be capped at the strike level of the written call. If the U.S. dollar strengthens relative to the currency of the hedged anticipated sales, the written

call option value of the collar strategy reduces to zero and the changes in the purchased put cash flows of the collar strategy would offset the decline in the expected future U.S. dollar equivalent cash flows of the hedged foreign currency sales.

The Company may also utilize forward contracts in its revenue hedging program. If the U.S. dollar strengthens relative to the currency of the hedged anticipated sales, the increase in the fair value of the forward contracts offsets the decrease in the expected future U.S. dollar cash flows of the hedged foreign currency sales. Conversely, if the U.S. dollar weakens, the decrease in the fair value of the forward contracts offsets the increase in the value of the anticipated foreign currency cash flows.

The fair values of these derivative contracts are recorded as either assets (gain positions) or liabilities (loss positions) in the Consolidated Balance Sheet. Changes in the fair value of derivative contracts are recorded each period in either current earnings or Other comprehensive income ("OCI"), depending on whether the derivative is designated as part of a hedge transaction and, if so, the type of hedge transaction. For derivatives that are designated as cash flow hedges, the effective portion of the unrealized gains or losses on these contracts is recorded in Accumulated other comprehensive income ("AOCI") and reclassified into Sales when the hedged anticipated revenue is recognized. The hedge relationship is highly effective and hedge ineffectiveness has been de minimis. For those derivatives which are not designated as cash flow hedges, but serve as economic hedges of forecasted sales, unrealized gains or losses are recorded in Sales each period. The cash flows from both designated and non-designated contracts are reported as operating activities in the Consolidated Statement of Cash Flows. The Company does not enter into derivatives for trading or speculative purposes.

The primary objective of the balance sheet risk management program is to mitigate the exposure of foreign currency denominated net monetary assets of foreign subsidiaries where the U.S. dollar is the functional currency from the effects of volatility in foreign exchange. In these instances, Merck principally utilizes forward exchange contracts, which enable the Company to buy and sell foreign currencies in the future at fixed exchange rates and economically offset the consequences of changes in foreign exchange from the monetary assets. Merck routinely enters into contracts to offset the effects of exchange on exposures denominated in developed country currencies, primarily the euro and Japanese yen. For exposures in developing country currencies, the Company will enter into forward contracts to partially offset the effects of exchange on exposures when it is deemed economical to do so based on a cost-benefit analysis that considers the magnitude of the exposure, the volatility of the exchange rate and the cost of the hedging instrument. The Company will also minimize the effect of exchange on monetary assets and liabilities by managing operating activities and net asset positions at the local level.

Monetary assets and liabilities denominated in a currency other than the functional currency of a given subsidiary are remeasured at spot rates in effect on the balance sheet date with the effects of changes in spot rates reported in Other (income) expense, net. The forward contracts are not designated as hedges and are marked to market through Other (income) expense, net. Accordingly, fair value changes in the forward contracts help mitigate the changes in the value of the remeasured assets and liabilities attributable to changes in foreign currency exchange rates, except to the extent of the spot-forward differences. These differences are not significant due to the short-term nature of the contracts, which typically have average maturities at inception of less than one year.

The Company also uses forward exchange contracts to hedge its net investment in foreign operations against movements in exchange rates. The forward contracts are designated as hedges of the net investment in a foreign operation. The Company hedges a portion of the net investment in certain of its foreign operations and measures ineffectiveness based upon changes in spot foreign exchange rates. The effective portion of the unrealized gains or losses on these contracts is recorded in foreign currency translation adjustment within OCI, and remains in AOCI until either the sale or complete or substantially complete liquidation of the subsidiary. The cash flows from these contracts are reported as investing activities in the Consolidated Statement of Cash Flows.

Foreign exchange risk is also managed through the use of foreign currency debt. The Company's senior unsecured euro-denominated notes have been designated as, and are effective as, economic hedges of the net investment in a foreign operation. Accordingly, foreign currency transaction gains or losses due to spot rate fluctuations on the euro-denominated debt instruments are included in foreign currency translation adjustment within OCI. Included in the cumulative translation adjustment are pretax gains of $40 million and $92 million for the first six months of 2013

and 2012, respectively, from the euro-denominated notes.

Interest Rate Risk Management

The Company may use interest rate swap contracts on certain investing and borrowing transactions to manage its net exposure to interest rate changes and to reduce its overall cost of borrowing. The Company does not use leveraged swaps and, in general, does not leverage any of its investment activities that would put principal capital at risk. There were no interest rate swaps outstanding as of December 31, 2012.

During the second quarter of 2013, the Company entered into nine pay-floating, received-fixed interest rate swap contracts designated as fair value hedges of fixed-rate notes in which the notional amounts match the amount of the hedged fixed-rate notes.

Notes to Interim Consolidated Financial Statements (unaudited) (continued)

There are four swaps maturing in 2016 with notional amounts of $250 million each that effectively convert the Company's 0.70% fixed-rate notes due 2016 to floating-rate instruments; four swaps maturing in 2018 with notional amounts of $250 million each that effectively convert the Company's 1.30% fixed-rate notes due 2018 into floating-rate instruments; and one swap with a notional amount of $200 million that effectively converts a portion of the Company's 6.00% fixed-rate notes due 2017 to floating-rate instruments. In July 2013, the Company entered into two additional interest rate swap contracts, one with a notional amount of $250 million and one with a notional amount of $300 million, that effectively convert a portion of the Company's 6.00% fixed-rate notes due 2017 to floating-rate instruments. The interest rate swap contracts are designated hedges of the fair value changes in the notes attributable to changes in the benchmark London Interbank Offered Rate ("LIBOR") swap rate. The fair value changes in the notes attributable to changes in the LIBOR are recorded in interest expense and offset by the fair value changes in the swap contracts. The cash flows from these contracts are reported as operating activities in the Consolidated Statement of Cash Flows.

Presented in the table below is the fair value of derivatives on a gross basis segregated between those derivatives that are designated as hedging instruments and those that are not designated as hedging instruments:

		June 30, 2013			December 31, 2012		
		Fair Value of Derivative			Fair Value of Derivative		
($ in millions)	Balance Sheet Caption	Asset	Liability	U.S. Dollar Notional	Asset	Liability	U.S. Dollar Notional
Derivatives Designated as Hedging Instruments							
Interest rate swap contracts (non-current)	Other assets	$1	$—	$ 200	$—	$—	$ —
Interest rate swap contracts (non-current)	Deferred income taxes and noncurrent liabilities	—	33	2,000	—	—	—
Foreign exchange contracts (current)	Deferred income taxes and other current assets	544	—	5,721	281	—	6,646
Foreign exchange contracts (non-current)	Other assets	603	—	6,103	387	—	5,989
Foreign exchange contracts (current)	Accrued and other current liabilities	—	3	659	—	13	938
Foreign exchange contracts (non-current)	Deferred income taxes and noncurrent liabilities	—	4	440	—	—	—
		$1,148	$40	$ 15,123	$668	$13	$ 13,573
Derivatives Not Designated as Hedging Instruments							
Foreign exchange contracts (current)	Deferred income taxes and other current assets	$144	$—	$ 5,504	$55	$—	$ 4,548
Foreign exchange contracts (non-current)	Other assets	—	—	—	8	—	232
Foreign exchange contracts (current)	Accrued and other current liabilities	—	58	3,288	—	216	8,203
		$144	$58	$ 8,792	$63	$216	$ 12,983
		$1,292	$98	$ 23,915	$731	$229	$ 26,556

As noted above, the Company records its derivatives on a gross basis in the Consolidated Balance Sheet. The Company has master netting agreements with several of its financial institution counterparties (see Concentrations of Credit Risk below). The following table provides information on the Company's derivative positions subject to these master netting arrangements as if they were presented on a net basis, allowing for the right of offset by counterparty and cash collateral exchanged per the master agreements and related credit support annexes:

	June 30, 2013		December 31, 2012	
($ in millions)	Asset	Liability	Asset	Liability
Gross amounts recognized in the consolidated balance sheet	$1,292	$98	$731	$229
Gross amount subject to offset in master netting arrangements	(94)	(92)	(195)	(195)
not offset in the consolidated balance sheet				
Cash collateral (received) posted	(855)	—	(305)	—
Net amounts	$343	$6	$231	$34

Notes to Interim Consolidated Financial Statements (unaudited) (continued)

The table below provides information on the location and pretax gain or loss amounts for derivatives that are: (i) designated in a fair value hedging relationship, (ii) designated in a foreign currency cash flow hedging relationship, (iii) designated in a foreign currency net investment hedging relationship and (iv) not designated in a hedging relationship:

	Three Months Ended June 30,		Six Months Ended June 30,	
($ in millions)	2013	2012	2013	2012
Derivatives designated in a fair value hedging relationship				
Interest rate swap contracts				
Amount of loss recognized in Other (income) expense, net on derivatives	$33	$—	$33	$—
Amount of gain recognized in Other (income) expense, net on hedged item	(33)	—	(33)	—
Derivatives designated in foreign currency cash flow hedging relationships				
Foreign exchange contracts				
Amount of loss reclassified from AOCI to Sales	2	26	34	53
Amount of gain recognized in OCI on derivatives	(36)	(154)	(385)	(34)
Derivatives designated in foreign currency net investment hedging relationships				
Foreign exchange contracts				
Amount of gain recognized in Other (income) expense, net on derivatives [1]	(1)	(2)	(3)	(11)
Amount of (gain) loss recognized in OCI on derivatives	(65)	86	(244)	(56)
Derivatives not designated in a hedging relationship				
Foreign exchange contracts				
Amount of gain recognized in Other (income) expense, net on derivatives [2]	(32)	(279)	(8)	(26)
Amount of loss (gain) recognized in Sales on hedged item	7	—	(3)	—

(1) There was no ineffectiveness on the hedge. Represents the amount excluded from hedge effectiveness testing.

(2) These derivative contracts mitigate changes in the value of remeasured foreign currency denominated monetary assets and liabilities attributable to changes in foreign currency exchange rates.

At June 30, 2013, the Company estimates $59 million of pretax net unrealized gains on derivatives maturing within the next 12 months that hedge foreign currency denominated sales over that same period will be reclassified from AOCI to Sales. The amount ultimately reclassified to Sales may differ as foreign exchange rates change. Realized gains and losses are ultimately determined by actual exchange rates at maturity.

Investments in Debt and Equity Securities

Information on available-for-sale investments is as follows:

	June 30, 2013				December 31, 2012			
($ in millions)	Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses
Corporate notes and bonds	$6,222	$ 6,243	$20	$(41)	$5,063	$ 5,013	$52	$(2)
Commercial paper	2,240	2,240	—	—	2,150	2,150	—	—
U.S. government and agency securities	1,339	1,351	—	(12)	1,206	1,204	2	—
Asset-backed securities	931	935	1	(5)	837	835	3	(1)
Mortgage-backed securities	538	543	1	(6)	435	436	2	(3)
Foreign government bonds	81	82	—	(1)	108	107	1	—

Equity securities	444	393	51	—	403	370	33	—
	$11,795	$ 11,787	$73	$(65)	$10,202	$ 10,115	$93	$(6)

Available-for-sale debt securities included in Short-term investments totaled $3.0 billion at June 30, 2013. Of the remaining debt securities, $7.5 billion mature within five years. At June 30, 2013 and December 31, 2012, there were no debt securities pledged as collateral.

Notes to Interim Consolidated Financial Statements (unaudited) (continued)

Fair Value Measurements

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The Company uses a fair value hierarchy which maximizes the use of observable inputs and minimizes the use of unobservable inputs when measuring fair value. There are three levels of inputs used to measure fair value with Level 1 having the highest priority and Level 3 having the lowest:

Level 1 - Quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2 - Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 - Unobservable inputs that are supported by little or no market activity. Level 3 assets are those whose values are determined using pricing models, discounted cash flow methodologies, or similar techniques with significant unobservable inputs, as well as instruments for which the determination of fair value requires significant judgment or estimation.

If the inputs used to measure the financial assets and liabilities fall within more than one level described above, the categorization is based on the lowest level input that is significant to the fair value measurement of the instrument.

Financial Assets and Liabilities Measured at Fair Value on a Recurring Basis

Financial assets and liabilities measured at fair value on a recurring basis are summarized below:

	Fair Value Measurements Using				Fair Value Measurements Using			
	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
($ in millions)	June 30, 2013				December 31, 2012			
Assets								
Investments								
Corporate notes and bonds	$—	$ 6,222	$ —	$6,222	$—	$ 5,063	$ —	$5,063
Commercial paper	—	2,240	—	2,240	—	2,150	—	2,150
U.S. government and agency securities	—	1,339	—	1,339	—	1,206	—	1,206
Asset-backed securities [1]	—	931	—	931	—	837	—	837
Mortgage-backed securities [1]	—	538	—	538	—	435	—	435
Foreign government bonds	—	81	—	81	—	108	—	108
Equity securities	212	—	—	212	196	—	—	196
	212	11,351	—	11,563	196	9,799	—	9,995
Other assets								
Securities held for employee compensation	193	39	—	232	169	38	—	207
Derivative assets [2]								
Purchased currency options	—	953	—	953	—	546	—	546
	—	338	—	338	—	185	—	185

Forward exchange contracts								
Interest rate swaps	—	1	—	1	—	—	—	—
	—	1,292	—	1,292	—	731	—	731
Total assets	$405	$ 12,682	$ —	$13,087	$365	$ 10,568	$ —	$10,933
Liabilities								
Derivative liabilities [2]								
Forward exchange contracts	$—	$ 63	$ —	$63	$—	$ 216	$ —	$216
Written currency options	—	2	—	2	—	13	—	13
Interest rate swaps	—	33	—	33	—	—	—	—
Total liabilities	$—	$ 98	$ —	$98	$—	$ 229	$ —	$229

(1) Primarily all of the asset-backed securities are highly-rated (Standard & Poor's rating of AAA and Moody's Investors Service rating of Aaa), secured primarily by credit card, auto loan, and home equity receivables, with weighted-average lives of primarily 5 years or less. Mortgage-backed securities represent AAA-rated securities issued or unconditionally guaranteed as to payment of principal and interest by U.S. government agencies.

(2) The fair value determination of derivatives includes the impact of the credit risk of counterparties to the derivatives and the Company's own credit risk, the effects of which were not significant.

Notes to Interim Consolidated Financial Statements (unaudited) (continued)

There were no transfers between Level 1 and Level 2 during the first six months of 2013. As of June 30, 2013, Cash and cash equivalents of $15.1 billion included $14.3 billion of cash equivalents (which would be considered Level 2 in the fair value hierarchy).

Other Fair Value Measurements

Some of the Company's financial instruments, such as cash and cash equivalents, receivables and payables, are reflected in the balance sheet at carrying value, which approximates fair value due to their short-term nature.

The estimated fair value of loans payable and long-term debt (including current portion) at June 30, 2013 was $29.0 billion compared with a carrying value of $28.1 billion and at December 31, 2012 was $22.8 billion compared with a carrying value of $20.6 billion. Fair value was estimated using recent observable market prices and would be considered Level 2 in the fair value hierarchy.

Concentrations of Credit Risk

On an ongoing basis, the Company monitors concentrations of credit risk associated with corporate and government issuers of securities and financial institutions with which it conducts business. Credit exposure limits are established to limit a concentration with any single issuer or institution. Cash and investments are placed in instruments that meet high credit quality standards, as specified in the Company's investment policy guidelines. Approximately one-third of the Company's cash and cash equivalents are invested in two highly rated money market funds.

The majority of the Company's accounts receivable arise from product sales in the United States and Europe and are primarily due from drug wholesalers and retailers, hospitals, government agencies, managed health care providers and pharmacy benefit managers. The Company monitors the financial performance and creditworthiness of its customers so that it can properly assess and respond to changes in their credit profile. The Company also continues to monitor economic conditions, including the volatility associated with international sovereign economies, and associated impacts on the financial markets and its business, taking into consideration the global economic downturn and the sovereign debt issues in certain European countries. The Company continues to monitor the credit and economic conditions within Greece, Italy, Spain, and Portugal, among other members of the EU. These economic conditions, as well as inherent variability of timing of cash receipts, have resulted in, and may continue to result in, an increase in the average length of time that it takes to collect accounts receivable outstanding. As such, time value of money discounts have been recorded for those customers for which collection of accounts receivable is expected to be in excess of one year. At June 30, 2013 and December 31, 2012, Other assets included $490 million and $473 million, respectively, of accounts receivable not expected to be collected within one year. The Company does not expect to have write-offs or adjustments to accounts receivable which would have a material adverse effect on its financial position, liquidity or results of operations.

At June 30, 2013, the Company's accounts receivable in Greece, Italy, Spain and Portugal totaled approximately $1.2 billion. Of this amount, hospital and public sector receivables were approximately $825 million in the aggregate, of which approximately 11%, 38%, 40% and 11% related to Greece, Italy, Spain and Portugal, respectively. At June 30, 2013, the Company's total accounts receivable outstanding for more than one year were approximately $350 million, of which approximately 60% related to accounts receivable in Greece, Italy, Spain and Portugal, mostly comprised of hospital and public sector receivables.

Additionally, the Company continues to expand in the emerging markets. Payment terms in these markets tend to be longer, resulting in an increase in accounts receivable balances in certain of these markets.

Derivative financial instruments are executed under International Swaps and Derivatives Association master agreements. The master agreements with several of the Company's financial institution counterparties also include credit support annexes. These annexes contain provisions that require collateral to be exchanged depending on the value of the derivative assets and liabilities, the Company's credit rating, and the credit rating of the counterparty. As of June 30, 2013 and December 31, 2012, the Company had received cash collateral of $855 million and $305 million, respectively, from various counterparties and the obligation to return such collateral is recorded in Accrued and other current liabilities. The Company had not advanced any cash collateral to counterparties as of June 30, 2013 or December 31, 2012.

Notes to Interim Consolidated Financial Statements (unaudited) (continued)

5. Inventories

Inventories consisted of:

($ in millions)	June 30, 2013	December 31, 2012
Finished goods	$2,214	$1,924
Raw materials and work in process	5,783	5,921
Supplies	235	244
Total (approximates current cost)	8,232	8,089
Increase to LIFO costs	49	52
	$8,281	$8,141
Recognized as:		
Inventories	$6,766	$6,535
Other assets	1,515	1,606

Amounts recognized as Other assets are comprised almost entirely of raw materials and work in process inventories. At both June 30, 2013 and December 31, 2012, these amounts included $1.4 billion of inventories not expected to be sold within one year. In addition, these amounts included $162 million and $196 million at June 30, 2013 and December 31, 2012, respectively, of inventories produced in preparation for product launches.

6. Other Intangibles

In connection with mergers and acquisitions, the Company measures the fair value of marketed products and research and development pipeline programs and capitalizes these amounts. During the second quarter and first six months of 2013, the Company recorded an intangible asset impairment charge of $330 million within Materials and production costs related to Saphris/Sycrest. During the second quarter, the Company reduced cash flow projections for Saphris/Sycrest as a result of reduced expectations in international markets and in the United States. These revisions to cash flows indicated that the Saphris/Sycrest intangible asset value was not recoverable on an undiscounted cash flows basis. Utilizing market participant assumptions, and considering several different scenarios, the Company concluded that its best estimate of the current fair value of the intangible asset related to Saphris/Sycrest was approximately $170 million, which resulted in the recognition of an impairment charge.

In addition, during the second quarter of 2013 and 2012, the Company recorded $234 million and $127 million, respectively, and during the first six months of 2013 and 2012, recorded $264 million and $136 million, respectively, of IPR&D impairment charges within Research and development expenses. Of the IPR&D impairment charges recorded in the second quarter and first six months of 2013, approximately $181 million related to the write-off of the intangible asset associated with preladenant as a result of the discontinuation of the clinical development program for this compound. In addition, the Company recorded impairment charges resulting from changes in cash flow assumptions for certain compounds. The remaining impairment charges for the first six months of 2013 and the charges in the second quarter and first six months of 2012 reflect impairments primarily related to pipeline programs that had previously been deprioritized and were subsequently deemed to have no alternative use in the period. The Company may recognize additional non-cash impairment charges in the future related to other pipeline programs or marketed products and such charges could be material.

During the first quarter of 2013, the Company recorded goodwill and other intangible assets in connection with the formation of a joint venture with Supera (see Note 3).

7. Joint Ventures and Other Equity Method Affiliates

Equity income from affiliates reflects the performance of the Company’s joint ventures and other equity method affiliates and was comprised of the following:

	Three Months Ended June 30,		Six Months Ended June 30,	
($ in millions)	2013	2012	2013	2012
AstraZeneca LP	$105	$140	$230	$253
Other [1]	11	2	19	—
	$116	$142	$249	$253

[1] Includes results from Sanofi Pasteur MSD.

Notes to Interim Consolidated Financial Statements (unaudited) (continued)

AstraZeneca LP

In 1998, Merck and Astra completed the restructuring of the ownership and operations of their existing joint venture whereby Merck acquired Astra's interest in KBI Inc. ("KBI") and contributed KBI's operating assets to a new U.S. limited partnership, Astra Pharmaceuticals L.P. (the "Partnership"), in exchange for a 1% limited partner interest. Astra contributed the net assets of its wholly owned subsidiary, Astra USA, Inc., to the Partnership in exchange for a 99% general partner interest. The Partnership, renamed AstraZeneca LP ("AZLP") upon Astra's 1999 merger with Zeneca Group Plc, became the exclusive distributor of the products for which KBI retained rights.

In 2014, AstraZeneca has the option to purchase Merck's interest in KBI based in part on the value of Merck's interest in Nexium and Prilosec. AstraZeneca's option is exercisable between March 1, 2014 and April 30, 2014. If AstraZeneca chooses to exercise this option, the closing date is expected to be June 30, 2014. Under the amended agreement, AstraZeneca will make a payment to Merck upon closing of $327 million, reflecting an estimate of the fair value of Merck's interest in Nexium and Prilosec. This portion of the exercise price is subject to a true-up in 2018 based on actual sales from closing in 2014 to June 2018. The exercise price will also include an additional amount equal to a multiple of ten times Merck's average 1% annual profit allocation in the partnership for the three years prior to exercise. The Company believes that it is likely that AstraZeneca will exercise its option in 2014.

Summarized financial information for AZLP is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
($ in millions)	2013	2012	2013	2012
Sales	$1,142	$1,150	$2,300	$2,192
Materials and production costs	575	520	1,126	959
Other expense, net	419	350	801	732
Income before taxes [1]	$148	$280	$373	$501

(1) Merck's partnership returns from AZLP are generally contractually determined and are not based on a percentage of income from AZLP, other than with respect to Merck's 1% limited partnership interest.

8. Loans Payable, Long-Term Debt and Other Commitments

In May 2013, the Company completed an underwritten public offering of $6.5 billion senior unsecured notes consisting of $1.0 billion aggregate principal amount of 0.70% notes due 2016, $500 million aggregate principal amount of floating rate notes due 2016, $1.0 billion aggregate principal amount of 1.30% notes due 2018, $1.0 billion aggregate principal amount of floating rate notes due 2018, $1.75 billion aggregate principal amount of 2.80% notes due 2023 and $1.25 billion aggregate principal amount of 4.15% notes due 2043. Interest on the notes is payable semi-annually. The notes of each series are redeemable in whole or in part at any time at the Company's option at varying redemption prices. A substantial portion of the net proceeds from the notes were used to repurchase the Company's common stock pursuant to an accelerated share repurchase agreement in May 2013 (see Note 10).

9. Contingencies and Environmental Liabilities

The Company is involved in various claims and legal proceedings of a nature considered normal to its business, including product liability, intellectual property, and commercial litigation, as well as additional matters such as antitrust actions and environmental matters. Except for the Vioxx Litigation (as defined below) for which a separate assessment is provided in this Note, in the opinion of the Company, it is unlikely that the resolution of these matters will be material to the Company's financial position, results of operations or cash flows.

Given the preliminary nature of the litigation discussed below, including the Vioxx Litigation, and the complexities involved in these matters, the Company is unable to reasonably estimate a possible loss or range of possible loss for such matters until the Company knows, among other factors, (i) what claims, if any, will survive dispositive motion practice, (ii) the extent of the claims, including the size of any potential class, particularly when damages are not

specified or are indeterminate, (iii) how the discovery process will affect the litigation, (iv) the settlement posture of the other parties to the litigation and (v) any other factors that may have a material effect on the litigation.

The Company records accruals for contingencies when it is probable that a liability has been incurred and the amount can be reasonably estimated. These accruals are adjusted periodically as assessments change or additional information becomes available. For product liability claims, a portion of the overall accrual is actuarially determined and considers such factors as past experience, number of claims reported and estimates of claims incurred but not yet reported. Individually significant contingent

Notes to Interim Consolidated Financial Statements (unaudited) (continued)

losses are accrued when probable and reasonably estimable. Legal defense costs expected to be incurred in connection with a loss contingency are accrued when probable and reasonably estimable.

The Company's decision to obtain insurance coverage is dependent on market conditions, including cost and availability, existing at the time such decisions are made. The Company has evaluated its risks and has determined that the cost of obtaining product liability insurance outweighs the likely benefits of the coverage that is available and, as such, has no insurance for certain product liabilities effective August 1, 2004.

Vioxx Litigation

Product Liability Lawsuits

As previously disclosed, Merck is a defendant in approximately 90 federal and state lawsuits (the "Vioxx Product Liability Lawsuits") alleging personal injury or economic loss as a result of the purchase or use of Vioxx. Most of the remaining cases are coordinated in a multidistrict litigation in the U.S. District Court for the Eastern District of Louisiana (the "Vioxx MDL") before Judge Eldon E. Fallon.

There are pending in various U.S. courts putative class actions purportedly brought on behalf of individual purchasers or users of Vioxx seeking reimbursement for alleged economic loss. In the Vioxx MDL proceeding, approximately 30 such class actions remain. In June 2010, Merck moved to strike the class claims or for judgment on the pleadings regarding the master complaint, which includes the above-referenced cases, and briefing on that motion was completed in September 2010. The Vioxx MDL court heard oral argument on Merck's motion in October 2010 and took it under advisement.

In July 2013, Merck entered into a proposed settlement in the Vioxx MDL which would resolve Vioxx-related consumer economic loss claims asserted against the Company by all non-Missouri resident consumers who purchased Vioxx and seek to recover economic damages. Merck previously settled a similar Vioxx consumer class action in Missouri. Under the proposed settlement, Merck would pay up to $23 million to pay all properly documented claims submitted by class members, approved attorneys' fees and expenses, and approved settlement notice costs and certain other administrative expenses. The settlement is subject to court approval.

In 2008, a Missouri state court certified a class of Missouri plaintiffs seeking reimbursement for out-of-pocket costs relating to Vioxx. In October 2012, the parties executed a settlement agreement to resolve the litigation. The Company established a reserve of $39 million in the third quarter of 2012 in connection with that settlement agreement, which is the minimum amount that the Company is required to pay under the agreement. The court-approved program to notify class members about the settlement has been completed. The settlement was approved, and final judgment in the action has been entered. The court-approved process for class members to submit claims under the settlement is ongoing and will continue until October 7, 2013.

In Indiana, plaintiffs filed a motion to certify a class of Indiana Vioxx purchasers in a case pending before the Circuit Court of Marion County, Indiana. That case has been dormant for several years. In April 2010, a Kentucky state court denied Merck's motion for summary judgment and certified a class of Kentucky plaintiffs seeking reimbursement for out-of-pocket costs relating to Vioxx. The trial court subsequently entered an amended class certification order in January 2011. Merck appealed that order to the Kentucky Court of Appeals and, in February 2012, the Kentucky Court of Appeals reversed the trial court's amended class certification order and remanded the case to the trial court with instructions that the trial court vacate its order certifying the class. The plaintiff petitioned the Kentucky Supreme Court to review the Court of Appeals' order and, in November 2012, the Kentucky Supreme Court granted review. Briefing before the Kentucky Supreme Court is now complete and the court heard oral argument on May 15, 2013.

Merck has also been named as a defendant in lawsuits brought by state Attorneys General in five states. All of these actions except for the Kentucky action are in the Vioxx MDL proceeding. These actions allege that Merck misrepresented the safety of Vioxx. These suits seek recovery for expenditures on Vioxx by government-funded health care programs, such as Medicaid, and/or penalties for alleged Consumer Fraud Act violations. The Kentucky action is currently scheduled to proceed to trial in Kentucky state court in October 2013. On January 10, 2013, Merck finalized a settlement in the action filed by the Pennsylvania Attorney General under which Merck agreed to pay Pennsylvania $8.25 million in exchange for the dismissal of its lawsuit.

Shareholder Lawsuits

As previously disclosed, in addition to the Vioxx Product Liability Lawsuits, various putative class actions and individual lawsuits under federal securities laws and state laws have been filed against Merck and various current and former officers and directors (the "Vioxx Securities Lawsuits"). The Vioxx Securities Lawsuits are coordinated in a multidistrict litigation in the U.S. District Court for the District of New Jersey before Judge Stanley R. Chesler, and have been consolidated for all purposes. In August 2011, Judge Chesler granted in part and denied in part Merck's motion to dismiss the Fifth Amended Class Action Complaint in the consolidated securities action. Among other things, the claims based on statements made on or after the voluntary withdrawal

of Vioxx on September 30, 2004, have been dismissed. In October 2011, defendants answered the Fifth Amended Class Action Complaint. In April 2012, plaintiffs filed a motion for class certification and, on January 30, 2013, Judge Chesler granted that motion. On March 15, 2013, plaintiffs filed a motion for leave to amend their complaint to add certain allegations to expand the class period. On May 29, 2013, the court denied plaintiffs' motion for leave to amend their complaint to expand the class period, but granted plaintiffs' leave to amend their complaint to add certain allegations within the existing class period. On June 30, 2013, plaintiffs filed their Sixth Amended Class Action Complaint. On July 1, 2013, defendants answered the Sixth Amended Class Action Complaint. Fact discovery is now closed; expert discovery is currently proceeding in accordance with the court's scheduling order.

As previously disclosed, several individual securities lawsuits filed by foreign institutional investors also are consolidated with the Vioxx Securities Lawsuits. In October 2011, plaintiffs filed amended complaints in each of the pending individual securities lawsuits. Also in October 2011, a new individual securities lawsuit (the "KBC Lawsuit") was filed in the District of New Jersey by several foreign institutional investors; that case is also consolidated with the Vioxx Securities Lawsuits. In January 2012, defendants filed motions to dismiss in one of the individual lawsuits (the "ABP Lawsuit"). Briefing on the motions to dismiss was completed in March 2012. In August 2012, Judge Chesler granted in part and denied in part the motions to dismiss the ABP Lawsuit. Among other things, certain alleged misstatements and omissions were dismissed as inactionable and all state law claims were dismissed in full. In September 2012, defendants answered the complaints in all individual actions other than the KBC Lawsuit; on the same day, defendants moved to dismiss the complaint in the KBC Lawsuit on statute of limitations grounds. In December 2012, Judge Chesler denied the motion to dismiss the KBC Lawsuit and, on January 4, 2013, defendants answered the complaint in the KBC Lawsuit. Fact discovery is now closed; expert discovery is currently proceeding in the individual securities lawsuits together with expert discovery in the class action.

Insurance

The Company has Directors and Officers insurance coverage applicable to the Vioxx Securities Lawsuits with remaining stated upper limits of approximately $170 million, which is currently being used to partially fund the Company's legal fees. As a result of the previously disclosed insurance arbitration, additional insurance coverage for these claims should also be available, if needed, under upper-level excess policies that provide coverage for a variety of risks. There are disputes with the insurers about the availability of some or all of the Company's insurance coverage for these claims and there are likely to be additional disputes. The amounts actually recovered under the policies discussed in this paragraph may be less than the stated upper limits.

International Lawsuits

As previously disclosed, in addition to the lawsuits discussed above, Merck has been named as a defendant in litigation relating to Vioxx in Brazil, Canada, Europe and Israel (collectively, the "Vioxx International Lawsuits"). As previously disclosed, the Company has entered into an agreement to resolve all claims related to Vioxx in Canada pursuant to which the Company will pay a minimum of approximately $21 million but not more than an aggregate maximum of approximately $36 million. The agreement has been approved by courts in Canada's provinces.

Reserves

The Company believes that it has meritorious defenses to the remaining Vioxx Product Liability Lawsuits, Vioxx Securities Lawsuits and Vioxx International Lawsuits (collectively, the "Vioxx Lawsuits") and will vigorously defend against them. In view of the inherent difficulty of predicting the outcome of litigation, particularly where there are many claimants and the claimants seek indeterminate damages, the Company is unable to predict the outcome of these matters and, at this time, cannot reasonably estimate the possible loss or range of loss with respect to the remaining Vioxx Lawsuits. The Company has established a reserve with respect to the Canadian settlement and with respect to certain other Vioxx Product Liability Lawsuits, including the Missouri matter discussed above. The Company also has an immaterial remaining reserve relating to the previously disclosed Vioxx investigation for the non-participating states with which litigation is continuing. The Company has established no other liability reserves with respect to the Vioxx Litigation. Unfavorable outcomes in the Vioxx Litigation could have a material adverse effect on the Company's financial position, liquidity and results of operations.

Other Product Liability Litigation

Fosamax

As previously disclosed, Merck is a defendant in product liability lawsuits in the United States involving Fosamax (the "Fosamax Litigation"). As of June 30, 2013, approximately 5,075 cases, which include approximately 5,440 plaintiff groups, had been filed and were pending against Merck in either federal or state court, including one case which seeks class action certification, as well as damages and/or medical monitoring. In approximately 1,135 of these actions, plaintiffs allege, among other things, that they have suffered osteonecrosis of the jaw ("ONJ"), generally subsequent to invasive dental procedures, such as tooth extraction or dental implants and/or delayed healing, in association with the use of Fosamax. In addition, plaintiffs in approximately 3,940

of these actions generally allege that they sustained femur fractures and/or other bone injuries ("Femur Fractures") in association with the use of Fosamax.

Cases Alleging ONJ and/or Other Jaw Related Injuries

In August 2006, the Judicial Panel on Multidistrict Litigation (the "JPML") ordered that certain Fosamax product liability cases pending in federal courts nationwide should be transferred and consolidated into one multidistrict litigation (the "Fosamax ONJ MDL") for coordinated pre-trial proceedings. The Fosamax ONJ MDL has been transferred to Judge John Keenan in the U.S. District Court for the Southern District of New York. As a result of the JPML order, approximately 855 of the cases are before Judge Keenan. In the first Fosamax ONJ MDL trial, Boles v. Merck, the Fosamax ONJ MDL court declared a mistrial because the eight person jury could not reach a unanimous verdict. The Boles case was retried in June 2010 and resulted in a verdict in favor of the plaintiff in the amount of $8 million. Merck filed post-trial motions seeking judgment as a matter of law or, in the alternative, a new trial. In October 2010, the court denied Merck's post-trial motions but sua sponte ordered a remittitur reducing the verdict to $1.5 million. Plaintiff rejected the remittitur ordered by the court and requested a new trial on damages. Plaintiff and Merck subsequently entered into a confidential stipulation as to the amount of plaintiff's damages that enabled Merck to appeal the underlying judgment, and Merck filed its appeal in the Boles case in October 2012. Prior to 2013, three other cases were tried to verdict in the Fosamax ONJ MDL. Defense verdicts in favor of Merck were returned in each of those three cases. Plaintiffs have filed an appeal in two of the cases – Graves v. Merck and Secrest v. Merck. On January 30, 2013, the U.S. Court of Appeals for the Second Circuit affirmed the judgment in Merck's favor in Secrest. Plaintiff in the Secrest case subsequently filed a petition for a writ of certiorari with the U.S. Supreme Court, but that petition was denied on June 3, 2013.

In February 2011, Judge Keenan ordered that there will be two further bellwether trials conducted in the Fosamax ONJ MDL. Spano v. Merck and Jellema v. Merck were selected by the court to be tried in 2012, but each case was dismissed by the plaintiffs. In March 2012, the court selected Scheinberg v. Merck as the next case to be tried. Trial in the Scheinberg case began on January 14, 2013 and, on February 5, 2013, the jury returned a mixed verdict, finding in favor of Merck on plaintiff's design defect claim, and finding in favor of plaintiff on her failure to warn claim and awarding her $285 thousand in compensatory damages. Merck's post-trial motion for judgment as a matter of law in the Scheinberg case was denied on July 1, 2013, and the Company has filed an appeal with the U.S. Court of Appeals for the Second Circuit.

In November 2012, Judge Keenan issued an order requiring plaintiffs who do not allege certain types of specific injuries to provide expert reports in support of their claims. The deadlines for submission of these reports were staggered throughout the first half of 2013, and failure to comply with the order may result in dismissal of a plaintiff's claim. To date, the claims of more than 335 plaintiffs subject to the order have been dismissed with prejudice.

In addition, in July 2008, an application was made by the Atlantic County Superior Court of New Jersey requesting that all of the Fosamax cases pending in New Jersey be considered for mass tort designation and centralized management before one judge in New Jersey. In October 2008, the New Jersey Supreme Court ordered that all pending and future actions filed in New Jersey arising out of the use of Fosamax and seeking damages for existing dental and jaw-related injuries, including ONJ, but not solely seeking medical monitoring, be designated as a mass tort for centralized management purposes before Judge Carol E. Higbee in Atlantic County Superior Court. As of June 30, 2013, approximately 275 ONJ cases were pending against Merck in Atlantic County, New Jersey. In July 2009, Judge Higbee entered a Case Management Order (and various amendments thereto) setting forth a schedule that contemplates completing fact and expert discovery in an initial group of cases to be reviewed for trial. In February 2011, the jury in Rosenberg v. Merck, the first trial in the New Jersey coordinated proceeding, returned a verdict in Merck's favor. In April 2012, the jury in Sessner v. Merck, the second case tried in New Jersey, also returned a verdict in Merck's favor. Plaintiffs have filed an appeal in both cases. On March 25, 2013, the New Jersey Appellate Division affirmed the judgment in Merck's favor in the Rosenberg case.

In California, the parties are reviewing the claims of two plaintiffs in the Carrie Smith, et al. v. Merck case and the claims in Pedrojetti v. Merck. The cases of one or more of these plaintiffs may be tried in 2013 or 2014.

Discovery is ongoing in the Fosamax ONJ MDL litigation, the New Jersey coordinated proceeding, and the remaining jurisdictions where Fosamax ONJ cases are pending. The Company intends to defend against these lawsuits.

Cases Alleging Femur Fractures

In March 2011, Merck submitted a Motion to Transfer to the JPML seeking to have all federal cases alleging Femur Fractures consolidated into one multidistrict litigation for coordinated pre-trial proceedings. The Motion to Transfer was granted in May 2011, and all federal cases involving allegations of Femur Fracture have been or will be transferred to a multidistrict litigation in the District of New Jersey (the "Fosamax Femur Fracture MDL"). As a result of the JPML order, approximately 1,075 cases were pending in the Fosamax Femur Fracture MDL as of June 30, 2013. A Case Management Order has been entered that

requires the parties to review 40 cases (later reduced to 33 cases). Judge Joel Pisano selected four cases from that group to be tried as the initial bellwether cases in the Fosamax Femur Fracture MDL. The first bellwether case, Glynn v. Merck, began on April 8, 2013, and the jury returned a verdict in Merck's favor on April 29, 2013; in addition, on June 27, 2013, Judge Pisano granted Merck's motion for judgment as a matter of law in the Glynn case and held that the plaintiff's failure to warn claim was preempted by federal law. Plaintiff Glynn did not appeal that ruling and the Glynn judgment entered in Merck's favor is now final. The second bellwether case, Zessin v. Merck, which was set to be tried in September 2013, is currently being held in abeyance, as are the trial dates for the remaining bellwether cases, Young v. Merck and Johnson v. Merck.

As of June 30, 2013, approximately 2,660 cases alleging Femur Fractures have been filed in New Jersey state court and are pending before Judge Higbee in Atlantic County Superior Court. The parties have selected an initial group of 30 cases to be reviewed through fact discovery. The first trial of the New Jersey state Femur Fracture cases, Su v. Merck, began on March 11, 2013, but a mistrial was declared on March 28, 2013 after the plaintiff suffered a serious medical issue unrelated to her use of Fosamax that prevented her from proceeding with the trial. The next trial, Unanski v. Merck, was set to be tried beginning November 4, 2013, but has been continued and is expected to be tried in 2014.

As of June 30, 2013, approximately 470 cases alleging Femur Fractures have been filed in California state court. A petition was filed seeking to coordinate all Femur Fracture cases filed in California state court before a single judge in Orange County, California. The petition was granted and Judge Steven Perk is now presiding over the coordinated proceedings. No scheduling order has yet been entered.

Additionally, there are seven Femur Fracture cases pending in other state courts.

Discovery is ongoing in the Fosamax Femur Fracture MDL and in state courts where Femur Fracture cases are pending and the Company intends to defend against these lawsuits.

Januvia/Janumet

As previously disclosed, Merck is a defendant in product liability lawsuits in the United States involving Januvia and/or Janumet. As of June 30, 2013, there were approximately 60 cases, which include approximately 65 plaintiff groups, filed and pending against Merck alleging that use of Januvia and/or Janumet caused the development of pancreatic cancer. These complaints were filed in several different state and federal courts, with the majority filed in the United States District Court for the Southern District of California. On April 5, 2013, a law firm representing certain plaintiffs filed a request with the JPML to create a federal MDL for lawsuits alleging pancreatic cancer due to use of the following medicines: Januvia, Janumet, and Byetta and Victoza, the latter two of which are products manufactured by other pharmaceutical companies. In its MDL request, the law firm asked the JPML to appoint Judge Anthony Battaglia of the United States District Court for the Southern District of California as the MDL Judge. On April 29, 2013, Merck and the other defendant manufacturers individually filed responses, all of which agreed that Judge Battaglia should preside if the JPML determines that an MDL is warranted. A hearing before the JPML concerning the motion was held on July 25, 2013. The Company intends to defend against these lawsuits.

NuvaRing

As previously disclosed, beginning in May 2007, a number of complaints were filed in various jurisdictions asserting claims against the Company's subsidiaries Organon USA, Inc., Organon Pharmaceuticals USA, Inc., Organon International (collectively, "Organon"), and the Company arising from Organon's marketing and sale of NuvaRing, a combined hormonal contraceptive vaginal ring. The plaintiffs contend that Organon and Schering-Plough, among other things, failed to adequately design and manufacture NuvaRing and failed to adequately warn of the alleged increased risk of venous thromboembolism ("VTE") posed by NuvaRing, and/or downplayed the risk of VTE. The plaintiffs seek damages for injuries allegedly sustained from their product use, including some alleged deaths, heart attacks and strokes. The majority of the cases are currently pending in a federal multidistrict litigation (the "NuvaRing MDL") venued in Missouri and in a coordinated proceeding in New Jersey state court.

As of June 30, 2013, there were approximately 1,500 NuvaRing cases. Of these cases, approximately 1,285 are or will be pending in the NuvaRing MDL in the U.S. District Court for the Eastern District of Missouri before Judge Rodney Sippel, and approximately 200 are pending in coordinated proceedings in the Bergen County Superior Court of New Jersey before Judge Brian R. Martinotti. Nine additional cases are pending in various other state courts, including two

cases in a coordinated state proceeding in the San Francisco Superior Court in California before Judge John E. Munter.

Pursuant to orders of Judge Sippel in the NuvaRing MDL, the parties originally selected a pool of more than 20 cases to prepare for trial and that pool was then narrowed to seven cases from which the first trials in the NuvaRing MDL will be selected. Judge Sippel recently denied the Company's motion for summary judgment in the first NuvaRing MDL trial which is expected to take place in January 2014.

Notes to Interim Consolidated Financial Statements (unaudited) (continued)

Pursuant to Judge Martinotti's order in the New Jersey proceeding, the parties selected nine trial pool cases to be prepared for trial. The plaintiffs voluntarily dismissed with prejudice two of the trial pool cases while the Company's summary judgment motions were pending. Judge Martinotti granted the Company's motions for summary judgment with respect to each of the remaining seven trial pool cases. While this ruling means there will not be a trial in New Jersey in June 2013 as previously expected, it is not yet known how this decision will impact the remaining cases. The Company has certain insurance coverage available to it, which is currently being used to partially fund the Company's legal fees. The Company intends to defend against these lawsuits.

Propecia/Proscar

As previously disclosed, Merck is a defendant in product liability lawsuits in the United States involving Propecia and/or Proscar. As of June 30, 2013, approximately 1,040 lawsuits involving a total of approximately 1,370 plaintiffs (in some instances spouses are joined as plaintiffs in the suits) who allege that they have experienced persistent sexual side effects following cessation of treatment with Propecia and/or Proscar have been filed against Merck. Approximately 25 of the plaintiffs also allege that Propecia or Proscar has caused or can cause prostate cancer or male breast cancer. The lawsuits have been filed in various federal courts and in state court in New Jersey. The federal lawsuits have been consolidated for pretrial purposes in a federal MDL before Judge John Gleeson of the Eastern District of New York. The matters pending in state court in New Jersey have been consolidated before Judge Jessica Mayer in Middlesex County. The Company intends to defend against these lawsuits.

Vytorin/Zetia Litigation

As previously disclosed, in April 2008, a Merck shareholder filed a putative class action lawsuit in federal court which has been consolidated in the District of New Jersey with another federal securities lawsuit under the caption In re Merck & Co., Inc. Vytorin Securities Litigation. An amended consolidated complaint was filed in October 2008. A second amended consolidated complaint was filed in February 2012, and named as defendants Merck; Merck/Schering-Plough Pharmaceuticals; MSP Distribution Services (C) LLC; MSP Singapore Company LLC; and certain of the Company's current and former officers and directors. The complaint alleged that Merck delayed releasing unfavorable results of the ENHANCE clinical trial regarding the efficacy of Vytorin and that Merck made false and misleading statements about expected earnings, knowing that once the results of the ENHANCE study were released, sales of Vytorin would decline and Merck's earnings would suffer. On February 14, 2013, Merck announced that it had reached an agreement in principle with plaintiffs to settle this matter for $215 million. On March 11, 2013, the court stayed all proceedings pending submission of the agreement for court approval. On June 4, 2013, plaintiffs moved for preliminary approval of the settlement, which the court granted on June 7, 2013. On July 2, 2013, plaintiffs moved for final approval of the settlement and the proposed plan of allocation. A final fairness hearing has been scheduled for October 1, 2013. The proposed settlement was reflected in the Company's 2012 financial results as discussed below.

There is a similar consolidated, putative class action securities lawsuit pending in the District of New Jersey, filed by a Schering-Plough shareholder against Schering-Plough and i