Merck & Co. Inc.
Form 10-Q
May 09, 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 March 31, 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 April 30, 2013: 3,019,611,844

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 þ	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 March 31,	
	2013	2012
Sales	$ 10,671	$ 11,731
Costs, Expenses and Other		
Materials and production	3,959	4,037
Marketing and administrative	2,987	3,074
Research and development	1,907	1,862
Restructuring costs	119	219
Equity income from affiliates	(133)	(110)
Other (income) expense, net	282	142
	9,121	9,224
Income Before Taxes	1,550	2,507
Taxes on Income	(66)	740
Net Income	$ 1,616	$ 1,767
Less: Net Income Attributable to Noncontrolling Interests	23	29
Net Income Attributable to Merck & Co., Inc.	$ 1,593	$ 1,738
Basic Earnings per Common Share Attributable to Merck & Co., Inc. Common Shareholders	$ 0.53	$ 0.57
Earnings per Common Share Assuming Dilution Attributable to Merck & Co., Inc. Common Shareholders	$ 0.52	$ 0.56
Dividends Declared per Common Share	$ 0.43	$ 0.42

MERCK & CO., INC. AND SUBSIDIARIES

INTERIM CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(Unaudited, $ in millions)

	Three Months Ended March 31,	
	2013	2012
Net Income Attributable to Merck & Co., Inc.	$ 1,593	$ 1,738
Other Comprehensive Income (Loss) Net of Taxes:		
Net unrealized gain (loss) on derivatives, net of reclassifications	236	(58)
Net unrealized gain on investments, net of reclassifications	1	29
Benefit plan net gain and prior service cost, net of amortization	161	
Cumulative translation adjustment	(345)	(56)
	53	(85)

Comprehensive Income Attributable to Merck & Co., Inc.	$ 1,646	$ 1,653

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)

	March 31, 2013	December 31, 2012
Assets		
Current Assets		
Cash and cash equivalents	$ 13,024	$ 13,451
Short-term investments	2,998	2,690
Accounts receivable (net of allowance for doubtful accounts of $144 in 2013 and $163 in 2012) (excludes accounts receivable of $482 in 2013 and $473 in 2012 classified in Other assets - see Note 4)	7,965	7,672
Inventories (excludes inventories of $1,445 in 2013 and $1,606 in 2012 classified in Other assets - see Note 5)	6,773	6,535
Deferred income taxes and other current assets	4,484	4,509
Total current assets	35,244	34,857
Investments	7,948	7,305
Property, Plant and Equipment, at cost, net of accumulated depreciation of $17,622 in 2013 and $17,385 in 2012	15,802	16,030
Goodwill	12,207	12,134
Other Intangibles, Net	28,108	29,083
Other Assets	6,891	6,723
	$ 106,200	$ 106,132
Liabilities and Equity		
Current Liabilities		
Loans payable and current portion of long-term debt	$ 4,736	$ 4,315
Trade accounts payable	2,084	1,753
Accrued and other current liabilities	9,569	9,737
Income taxes payable	1,075	1,200
Dividends payable	1,338	1,343
Total current liabilities	18,802	18,348
Long-Term Debt	16,089	16,254
Deferred Income Taxes and Noncurrent Liabilities	15,703	16,067
Merck & Co., Inc. Stockholders Equity		
Common stock, $0.50 par value Authorized - 6,500,000,000 shares Issued - 3,577,103,522 shares in 2013 and 2012	1,788	1,788
Other paid-in capital	40,727	40,646
Retained earnings	40,272	39,985
Accumulated other comprehensive loss	(4,629)	(4,682)
	78,158	77,737
Less treasury stock, at cost: 559,727,953 shares in 2013 and 550,468,221 shares in 2012	25,129	24,717
Total Merck & Co., Inc. stockholders equity	53,029	53,020
Noncontrolling Interests	2,577	2,443
Total equity	55,606	55,463
	$ 106,200	$ 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)

	Three Months Ended March 31,	
	2013	2012
Cash Flows from Operating Activities		
Net income	$ 1,616	$ 1,767
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,674	1,790
Intangible asset impairment charges	30	9
Equity income from affiliates	(133)	(110)
Dividends and distributions from equity affiliates	5	66
Deferred income taxes	(71)	(41)
Share-based compensation	67	76
Other	326	71
Net changes in assets and liabilities	(1,173)	(1,474)
Net Cash Provided by Operating Activities	2,341	2,154
Cash Flows from Investing Activities		
Capital expenditures	(351)	(331)
Purchases of securities and other investments	(4,010)	(2,725)
Proceeds from sales of securities and other investments	3,161	2,797
Other	47	(11)
Net Cash Used in Investing Activities	(1,153)	(270)
Cash Flows from Financing Activities		
Net change in short-term borrowings	880	634
Payments on debt	(506)	(2)
Purchases of treasury stock	(580)	(456)
Dividends paid to stockholders	(1,306)	(1,279)
Proceeds from exercise of stock options	92	379
Other	(1)	(1)
Net Cash Used in Financing Activities	(1,421)	(725)
Effect of Exchange Rate Changes on Cash and Cash Equivalents	(194)	(34)
Net (Decrease) Increase in Cash and Cash Equivalents	(427)	1,125
Cash and Cash Equivalents at Beginning of Year	13,451	13,531
Cash and Cash Equivalents at End of Period	$ 13,024	$ 14,656

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 $153 million and $279 million in the first quarter of 2013 and 2012, respectively, related to this program. Since inception of the Merger Restructuring Program through March 31, 2013, Merck has recorded total pretax accumulated costs of approximately $6.2 billion and eliminated approximately 23,140 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 $41 million and $14 million were recorded in the first quarter of 2013 and 2012, respectively, related to the 2008 Restructuring Program. Since inception of the 2008 Restructuring Program through March 31, 2013, Merck has recorded total pretax accumulated costs of $1.7 billion and eliminated approximately 6,450 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 2015,

with

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

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.

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 March 31, 2013			
($ in millions)	Separation Costs	Accelerated Depreciation	Other	Total
Merger Restructuring Program				
Materials and production	$	$ 31	$ 9	$ 40
Marketing and administrative		15		15
Research and development		15		15
Restructuring costs	65		18	83
	65	61	27	153
2008 Restructuring Program				
Materials and production			3	3
Marketing and administrative		2		2
Restructuring costs	32		4	36
	32	2	7	41
	$ 97	$ 63	$ 34	$ 194

	Three Months Ended March 31, 2012			
($ in millions)	Separation Costs	Accelerated Depreciation	Other	Total
Merger Restructuring Program				
Materials and production	$	$ (21)	$ 17	$ (4)
Marketing and administrative		23	1	24
Research and development		41	4	45
Restructuring costs	180		34	214
	180	43	56	279
2008 Restructuring Program				
Materials and production		2	7	9
Restructuring costs	2		3	5
	2	2	10	14
	$ 182	$ 45	$ 66	$ 293

Separation costs are associated with actual headcount reductions, as well as those headcount reductions which were probable and could be reasonably estimated. In the first quarter of 2013 and 2012, approximately 740 positions and 1,020 positions, respectively, were eliminated under the Merger Restructuring Program and approximately 50 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.

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

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 11) and share-based compensation costs.

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

The following table summarizes the charges and spending relating to Merger Restructuring Program and 2008 Restructuring Program activities for the three months ended March 31, 2013:

($ in millions)	Separation Costs	Accelerated Depreciation	Other	Total
Merger Restructuring Program				
Restructuring reserves January 1, 2013	$ 699	$	$ 19	$ 718
Expense	65	61	27	153
(Payments) receipts, net	(108)		(27)	(135)
Non-cash activity		(61)	(4)	(65)
Restructuring reserves March 31, 2013 [(1)]	$ 656	$	$ 15	$ 671
2008 Restructuring Program				
Restructuring reserves January 1, 2013	$ 77	$	$	$ 77
Expense	32	2	7	41
(Payments) receipts, net	(46)		(4)	(50)
Non-cash activity		(2)	(3)	(5)
Restructuring reserves March 31, 2013 [(1)]	$ 63	$	$	$ 63

[(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 will market, distribute and sell 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 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 three 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 (losses) of $78 million and $(44) million for the first three months of 2013 and 2012, respectively, from the euro-denominated notes.

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

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 March 31, 2013 or December 31, 2012.

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:

		March 31, 2013			December 31, 2012		
		Fair Value of Derivative		U.S. Dollar	Fair Value of Derivative		U.S. Dollar
($ in millions)	Balance Sheet Caption	Asset	Liability	Notional	Asset	Liability	Notional
Derivatives Designated as Hedging Instruments							
Foreign exchange contracts (current)	Deferred income taxes and other current assets	$ 580	$	$ 6,370	$ 281	$	$ 6,646
Foreign exchange contracts (non-current)	Other assets	596		6,101	387		5,989
Foreign exchange contracts (current)	Accrued and other current liabilities		3	748		13	938
		$ 1,176	$ 3	$ 13,219	$ 668	$ 13	$ 13,573
Derivatives Not Designated as Hedging Instruments							
Foreign exchange contracts (current)	Deferred income taxes and other current assets	$ 132	$	$ 6,237	$ 55	$	$ 4,548
Foreign exchange contracts (non-current)	Other assets	6		113	8		232
Foreign exchange contracts (current)	Accrued and other current liabilities		142	3,893		216	8,203
		$ 138	$ 142	$ 10,243	$ 63	$ 216	$ 12,983
		$ 1,314	$ 145	$ 23,462	$ 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:

	March 31, 2013		December 31, 2012	
($ in millions)	Asset	Liability	Asset	Liability
Gross amounts recognized in the consolidated balance sheet	$ 1,314	$ 145	$ 731	$ 229
Gross amount subject to offset in master netting arrangements not offset in the consolidated balance sheet	(115)	(115)	(195)	(195)
Gross amount not subject to master netting arrangements	(3)	(1)	(3)	(3)
Cash collateral (received) posted	(841)		(305)	
Net amounts	$ 355	$ 29	$ 228	$ 31

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 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 March 31,	
($ in millions)	2013	2012
Derivatives designated in foreign currency cash flow hedging relationships		
Foreign exchange contracts		
Amount of loss reclassified from *AOCI* to *Sales*	$ 32	$ 27
Amount of (gain) loss recognized in *OCI* on derivatives	(349)	120
Derivatives designated in foreign currency net investment hedging relationships		
Foreign exchange contracts		
Amount of gain recognized in *Other (income) expense, net* on derivatives [1]	(2)	(9)
Amount of gain recognized in *OCI* on derivatives	(180)	(142)
Derivatives not designated in a hedging relationship		
Foreign exchange contracts		
Amount of loss recognized in *Other (income) expense, net* on derivatives [2]	24	253
Amount of gain recognized in *Sales* on hedged item	(10)	

[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.*

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

At March 31, 2013, the Company estimates $42 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:

	March 31, 2013				December 31, 2012			
	Fair	Amortized	Gross Unrealized		Fair	Amortized	Gross Unrealized	
($ in millions)	Value	Cost	Gains	Losses	Value	Cost	Gains	Losses
Corporate notes and bonds	$ 5,807	$ 5,769	$ 41	$ (3)	$ 5,063	$ 5,013	$ 52	$ (2)
Commercial paper	2,229	2,229			2,150	2,150		
U.S. government and agency securities	1,205	1,203	2		1,206	1,204	2	
Asset-backed securities	878	876	3	(1)	837	835	3	(1)
Mortgage-backed securities	491	491	2	(2)	435	436	2	(3)
Foreign government bonds	121	120	1		108	107	1	
Equity securities	429	376	53		403	370	33	
	$ 11,160	$ 11,064	$ 102	$ (6)	$ 10,202	$ 10,115	$ 93	$ (6)

Available-for-sale debt securities included in *Short-term investments* totaled $3.0 billion at March 31, 2013. Of the remaining debt securities, $6.9 billion mature within five years. At March 31, 2013 and December 31, 2012, there were no debt securities pledged as collateral.

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.

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

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)	March 31, 2013				December 31, 2012			
Assets								
Investments								
Corporate notes and bonds	$	$ 5,807	$	$ 5,807	$	$ 5,063	$	$ 5,063
Commercial paper		2,229		2,229		2,150		2,150
U.S. government and agency securities		1,205		1,205		1,206		1,206
Asset-backed securities [1]		878		878		837		837
Mortgage-backed securities [1]		491		491		435		435
Foreign government bonds		121		121		108		108
Equity securities	215			215	196			196
	215	10,731		10,946	196	9,799		9,995
Other assets								
Securities held for employee compensation	183	31		214	169	38		207
Derivative assets [2]								
Purchased currency options		934		934		546		546
Forward exchange contracts		380		380		185		185
		1,314		1,314		731		731
Total assets	$ 398	$ 12,076	$	$ 12,474	$ 365	$ 10,568	$	$ 10,933
Liabilities								
Derivative liabilities [2]								
Forward exchange contracts	$	$ 142	$	$ 142	$	$ 216	$	$ 216
Written currency options		3		3		13		13
Total liabilities	$	$ 145	$	$ 145	$	$ 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.*

There were no transfers between Level 1 and Level 2 during the first three months of 2013. As of March 31, 2013, *Cash and cash equivalents* of $13.0 billion included $12.0 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 March 31, 2013 was $22.8 billion compared with a carrying value of $20.8 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 March 31, 2013 and December 31, 2012, *Other assets* included $482 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 March 31, 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 $800 million in the aggregate, of which approximately 18%, 38%, 36% and 9% related to Greece, Italy, Spain and Portugal, respectively. At March 31, 2013, the Company s total accounts receivable outstanding for more than one year were approximately $245 million, of which approximately 50% 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 March 31, 2013 and December 31, 2012, the Company had received cash collateral of $841 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 March 31, 2013 or December 31, 2012.

5. Inventories

Inventories consisted of:

($ in millions)	March 31, 2013	December 31, 2012
Finished goods	$ 2,055	$ 1,924
Raw materials and work in process	5,876	5,921
Supplies	240	244
Total (approximates current cost)	8,171	8,089
Increase to LIFO costs	47	52
	$ 8,218	$ 8,141
Recognized as:		
Inventories	$ 6,773	$ 6,535
Other assets	1,445	1,606

Amounts recognized as *Other assets* are comprised almost entirely of raw materials and work in process inventories. At March 31, 2013 and December 31, 2012, these amounts included $1.3 billion and $1.4 billion, respectively, of inventories not expected to be sold within one year. In addition, these amounts included $173 million and $196 million at March 31, 2013 and December 31, 2012, respectively, of inventories produced in preparation for product launches.

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

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 first quarter of 2013 and 2012, the Company recorded $30 million and $9 million, respectively, of IPR&D impairment charges within *Research and development* expenses primarily for 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 March 31,	
($ in millions)	2013	2012
AstraZeneca LP	$ 125	$ 113
Other [(1)]	8	(3)
	$ 133	$ 110

[(1)] *Includes results from Sanofi Pasteur MSD.*

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 March 31	
($ in millions)	2013	2012
Sales	$ 1,158	$ 1,042
Materials and production costs	552	478
Other expense, net	381	381

Income before taxes [(1)]	$ 225	$ 183

[(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.*

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

8. 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 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 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 has set oral argument for 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, which motion has been fully briefed. 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. Discovery is currently proceeding in the individual securities lawsuits together with 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 March 31, 2013, approximately 4,990 cases, which include approximately 5,585 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 1,210 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 3,780 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 940 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.* On April 30, 2013, plaintiff in the *Secrest* case filed a petition for writ of certiorari with the U.S. Supreme Court.

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. On March 5, 2013, Merck filed a post-trial motion for judgment as a matter of law in the *Scheinberg* case and that motion is still pending.

In November 2011, 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 are staggered throughout the first half of 2013, and failure to comply with the order may result in dismissal of a plaintiff s claim. The first deadline passed on February 20, 2013, and Merck submitted to the court on February 27, 2013 a list of several hundred plaintiffs who failed to comply with that first deadline. On March 13, 2013, Judge Keenan ordered that those plaintiffs who failed to provide reports by the February 20, 2013 deadline had 30 days to provide the required reports or, upon motion, the case may be dismissed with prejudice and/or the court may impose sanctions for failure to comply. To date, more than 225 plaintiffs subject to the order have dismissed their claims 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 March 31, 2013, approximately 265 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.

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 1,015 cases were pending in the *Fosamax* Femur Fracture MDL as of March 31, 2013. A Case Management Order has been entered that requires the parties to review 40 cases (later reduced to 33 cases). Judge Joel Pisano has 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. The *Zessin v. Merck* case was set to be tried in September 2013 but has been rescheduled for January 2014; the *Young v. Merck* and *Johnson v. Merck* cases are expected to be tried later in 2014.

As of March 31, 2013, approximately 2,305 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*, is currently set to be tried beginning November 4, 2013.

As of March 31, 2013, approximately 440 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 nine Femur Fracture cases pending in other state courts. A trial date has been set for August 12, 2013 for the *Barnes v. Merck* case pending in Alabama state court.

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 of March 31, 2013, there were 43 filed complaints against Merck alleging that plaintiffs use of *Januvia* and/or *Janumet* caused them to develop 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. 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 March 31, 2013, there were approximately 1,410 *NuvaRing* cases. Of these cases, approximately 1,190 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 210 are pending in coordinated proceedings in the Bergen County Superior Court of New Jersey before Judge Brian R. Martinotti. In addition, there are several cases pending in various other state courts. 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.

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 eight cases from which the first trials in the *NuvaRing* MDL will be selected. The first *NuvaRing* MDL trial is expected to take place in October of 2013. The Company has filed motions related to the admissibility of expert testimony and motions for summary judgment. Judge Sippel recently denied the majority of the Company s expert challenges. In one of the eight trial pool cases in which the Company moved for summary judgment, the plaintiff dismissed her case with prejudice. No date is set yet for any hearings on the Company s remaining summary judgment motions in the *NuvaRing* MDL.

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.

Propecia/Proscar

As previously disclosed, Merck is a defendant in product liability lawsuits in the United States involving *Propecia* and/or *Proscar*. As of March 31, 2013, approximately 540 lawsuits involving a total of approximately 760 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. 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 alleges 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. In December 2008, Merck and the

other defendants moved to dismiss this lawsuit on the grounds that the plaintiffs failed to state a claim for which relief can be granted. In September 2009, the court denied defendants motion to dismiss. In March 2012, defendants filed a motion for summary judgment. In September 2012, the court denied defendants motion for summary judgment and granted lead plaintiffs amended motion for class certification. On February 13, 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. 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 its former Chairman, President and Chief Executive Officer, Fred Hassan, under the caption *In re Schering-Plough Corporation/ENHANCE Securities Litigation*. The amended consolidated complaint was filed in September 2008 and names as defendants Schering-Plough; Merck/Schering-Plough Pharmaceuticals; certain of the Company s current and former officers and directors; and underwriters who participated in an August 2007 public offering of Schering-Plough s common and preferred stock. In December 2008, Schering-Plough and the other defendants filed motions to dismiss this lawsuit on the grounds that the plaintiffs failed to state a claim for which relief can be granted. In September 2009, the court denied defendants motions to dismiss. In March 2012, the Schering-Plough defendants filed a motion for partial summary judgment and the underwriter defendants filed a motion for summary judgment. In September 2012, the court denied defendants motions for summary judgment and granted lead plaintiffs amended motion for class certification. On February 13, 2013, Merck announced that it had reached an agreement in principle with plaintiffs to settle this matter for $473 million. On March 11, 2013, the court stayed all proceedings pending submission of the settlement agreement for court approval. If approved, this settlement will exhaust the remaining Directors and Officers insurance coverage applicable to the *Vytorin* lawsuits brought by the legacy Schering-Plough shareholders. The proposed settlement was reflected in the Company s 2012 financial results and, together with the settlement described in the preceding paragraph, resulted in an aggregate charge of $493 million after taking into account anticipated insurance recoveries of $195 million.

Commercial Litigation

AWP Litigation

As previously disclosed, the Company and/or certain of its subsidiaries remain defendants in cases brought by various states alleging manipulation by pharmaceutical manufacturers of Average Wholesale Prices (AWP), which are sometimes used by public and private payors in calculating provider reimbursement levels. The outcome of these lawsuits could include substantial damages, the imposition of substantial fines and penalties and injunctive or administrative remedies.

Since the start of 2012, the Company has settled certain AWP cases brought by the states of Alabama, Alaska, Kansas, Kentucky, Louisiana, Oklahoma, and Mississippi. The Company and/or certain of its subsidiaries continue to be defendants in cases brought by five states.

The Company has also been reinstated as a defendant in a putative class action in New Jersey Superior Court which alleges on behalf of third-party payers and individuals that manufacturers inflated drug prices by manipulation of AWPs and other means. This case was originally dismissed against the Company without prejudice in 2007. The Company intends to defend against this lawsuit.

Coupon Litigation

In 2012, as previously disclosed, a number of private health plans filed separate putative class action lawsuits against the Company alleging that Merck s coupon programs injured health insurers by reducing beneficiary co-payment amounts, thereby allegedly causing beneficiaries to purchase higher-priced drugs than they otherwise would have purchased and increasing the insurers reimbursement costs. The actions, which were assigned to a District Judge in the U.S. District Court for the District of New Jersey, sought damages and injunctive relief barring the Company from issuing coupons that would reduce beneficiary co-pays on behalf of putative nationwide classes of health insurers. Similar actions relating to manufacturer coupon programs have been filed against several other pharmaceutical manufacturers in a variety of federal courts. On April 29, 2013, the District Court dismissed all the actions against Merck without prejudice on the ground that plaintiffs had failed to demonstrate their standing to sue. Plaintiffs were given until June 3, 2013 to file amended complaints.

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

Patent Litigation

From time to time, generic manufacturers of pharmaceutical products file Abbreviated New Drug Applications (ANDAs) with the U.S. Food and Drug Administration (the FDA) seeking to market generic forms of the Company s products prior to the expiration of relevant patents owned by the Company. To protect its patent rights, the Company may file patent infringement lawsuits against such generic companies. Certain products of the Company (or products marketed via agreements with other companies) currently involved in such patent infringement litigation in the United States include: AzaSite, *Emend* for Injection, Integrilin, *Nasonex*, Nexium, *Vytorin* and *Zetia*. Similar lawsuits defending the Company s patent rights may exist in other countries. The Company intends to vigorously defend its patents, which it believes are valid, against infringement by generic companies attempting to market products prior to the expiration of such patents. As with any litigation, there can be no assurance of the outcomes, which, if adverse, could result in significantly shortened periods of exclusivity for these products and, with respect to products acquired through mergers and acquisitions, potentially significant intangible asset impairment charges.

AzaSite In May 2011, a patent infringement lawsuit was filed in the United States against Sandoz Inc. (Sandoz) in respect of Sandoz s application to the FDA seeking pre-patent expiry approval to market a generic version of AzaSite. The lawsuit automatically stays FDA approval of Sandoz s ANDA until October 2013 or until an adverse court decision, if any, whichever may occur earlier. A trial in the case is scheduled for July 2013.

Emend for Injection In May 2012, a patent infringement lawsuit was filed in the United States against Sandoz in respect of Sandoz s application to the FDA seeking pre-patent expiry approval to market a generic version of *Emend* for Injection. The lawsuit automatically stays FDA approval of Sandoz s ANDA until July 2015 or until an adverse court decision, if any, whichever may occur earlier. In June 2012, a patent infringement lawsuit was filed in the United States against Accord Healthcare, Inc. US, Accord Healthcare, Inc. and Intas Pharmaceuticals Ltd (collectively, Intas) in respect of Intas application to the FDA seeking pre-patent expiry approval to market a generic version of *Emend* for Injection. The lawsuit automatically stays FDA approval of Intas ANDA until July 2015 or until an adverse court decision, if any, whichever may occur earlier.

Integrilin In February 2009, a patent infringement lawsuit was filed (jointly with Millennium Pharmaceuticals, Inc.) in the United States against Teva Parenteral Medicines, Inc. (TPM) in respect of TPM s application to the FDA seeking pre-patent expiry approval to sell a generic version of Integrilin. In October 2011, the parties entered a settlement agreement allowing TPM to sell a generic version of Integrilin beginning June 2, 2015. In November 2012, a patent infringement lawsuit was filed against APP Pharmaceuticals, Inc. and Fresenius Kabi USA Inc. (collectively, APP) in respect of APP s application to the FDA seeking pre-patent expiry approval to sell a generic version of Integrilin. In March 2013, the parties entered into a settlement agreement allowing APP to sell a generic version of Integrilin beginning June 2, 2015.

Nasonex In December 2009, a patent infringement lawsuit was filed in the United States against Apotex Corp. (Apotex) in respect of Apotex s application to the FDA seeking pre-patent expiry approval to market a generic version of *Nasonex*. A trial in this matter was held in April 2012. A decision was issued in June 2012, holding that the Merck patent covering mometasone furoate monohydrate was valid, but that it was not infringed by Apotex s proposed product. An appeal hearing is scheduled for June 2013.

Nexium Patent infringement lawsuits were brought (jointly with AstraZeneca) in the United States against the following generic companies: Ranbaxy Laboratories Ltd., IVAX Pharmaceuticals, Inc. (later acquired by Teva Pharmaceuticals, Inc. (Teva)), Dr. Reddy s Laboratories, Sandoz, Lupin Ltd., Hetero Drugs Limited Unit III and Torrent Pharmaceuticals Ltd. in response to each generic company s application seeking pre-patent expiry approval to sell a generic version of Nexium. Settlements have been reached in each of these lawsuits, the terms of which provide that the respective generic company may bring a generic version of esomeprazole product to market on May 27, 2014. In addition, a patent infringement lawsuit was also filed (jointly with AstraZeneca) in February 2010 in the United States against Sun Pharma Global Fze (Sun Pharma) in respect of its application to the FDA seeking pre-patent expiry approval to sell a generic version of Nexium IV, which lawsuit was settled with an agreement which provides that Sun Pharma will be entitled to bring its generic esomeprazole IV product to market in the United States on January 1, 2014. Finally, additional patent infringement lawsuits have been filed (jointly with AstraZeneca) in the United States against Hanmi USA, Inc. (Hanmi) and Mylan Laboratories Limited (Mylan Labs) related to their applications to the FDA seeking pre-patent expiry approval to sell generic versions

of Nexium. The Hanmi and Mylan Labs applications to the FDA remain stayed until May 2013 and August 2014, respectively, or until earlier adverse court decisions, if any, whichever may occur earlier. A trial in the Hanmi case is scheduled for May 2013. In March 2013, a patent infringement lawsuit was filed (jointly with AstraZeneca) in the United States against Actavis, Inc./Watson Pharma Company (collectively, Actavis/Watson) in respect of Actavis/Watson s application to the FDA seeking pre-patent expiry approval to market a generic version of Nexium. The lawsuit automatically stays FDA approval of Actavis/Watson s ANDA until October 2015 or until an adverse court decision, if any, whichever may occur earlier.

Vytorin In December 2009, a patent infringement lawsuit was filed in the United States against Mylan Pharmaceuticals, Inc. (Mylan) in respect of Mylan s application to the FDA seeking pre-patent expiry approval to sell a generic version of *Vytorin*. A trial against Mylan jointly in respect of *Zetia* and *Vytorin* was conducted in December 2011. In April 2012, the court issued a decision finding the patent valid and enforceable. Accordingly, Mylan s ANDA will not be approvable until April 25, 2017. On February 7, 2013, the Court of Appeals for the Federal Circuit affirmed the lower court decision. In April 2013, the Federal Circuit denied Mylan s motion for rehearing en banc. In February 2010, a patent infringement lawsuit was filed in the United States against Teva in respect of Teva s application to the FDA seeking pre-patent expiry approval to sell a generic version of *Vytorin*. In July 2011, the patent infringement lawsuit was dismissed and Teva agreed not to sell generic versions of *Zetia* or *Vytorin* until the Company s exclusivity rights expire on April 25, 2017, except in certain circumstances. In August 2010, a patent infringement lawsuit was filed in the United States against Impax Laboratories Inc. (Impax) in respect of Impax s application to the FDA seeking pre-patent expiry approval to sell a generic version of *Vytorin*. An agreement was reached with Impax to stay the lawsuit pending the outcome of the lawsuit with Mylan. In October 2011, a patent infringement lawsuit was filed in the United States against Actavis, Inc. (Actavis) in respect to Actavis application to the FDA seeking pre-patent expiry approval to sell a generic version of *Vytorin*. An agreement was reached with Actavis to stay the lawsuit pending the outcome of the lawsuit with Mylan.

Zetia In March 2007, a patent infringement lawsuit was filed in the United States against Glenmark Pharmaceuticals Inc., USA and its parent corporation (collectively, Glenmark) in respect of Glenmark s application to the FDA seeking pre-patent expiry approval to sell a generic version of *Zetia*. In May 2010, Glenmark agreed to a settlement by virtue of which Glenmark will be permitted to launch its generic product in the United States on December 12, 2016, subject to receiving final FDA approval. In June 2010, a patent infringement lawsuit was filed in the United States against Mylan in respect of Mylan s application to the FDA seeking pre-patent expiry approval to sell a generic version of *Zetia*. A trial against Mylan jointly in respect of *Zetia* and *Vytorin* was conducted in December 2011. In April 2012, the court issued a decision finding the patent valid and enforceable. Accordingly, Mylan s ANDA will not be approvable until April 25, 2017. On February 7, 2013, the Court of Appeals for the Federal Circuit affirmed the lower court decision. In April 2013, the Federal Circuit denied Mylan s motion for rehearing en banc. In September 2010, a patent infringement lawsuit was filed in the United States against Teva in respect of Teva s application to the FDA seeking pre-patent expiry approval to sell a generic version of *Zetia*. In July 2011, the patent infringement lawsuit was dismissed without any rights granted to Teva. In September 2012, a patent infringement suit was filed in the United States against Sandoz in respect of Sandoz s application to the FDA seeking pre-patent expiry approval to market a generic version of *Zetia*. The lawsuit automatically stays FDA approval of Sandoz s ANDA until February 2015 or until an adverse court decision, if any, whichever may occur earlier.

Environmental Litigation

As previously disclosed, approximately 2,200 plaintiffs filed an amended complaint against Merck and 12 other defendants in U.S. District Court, Eastern District of California asserting claims under the Clean Water Act, the Resource Conservation and Recovery Act, as well as negligence and nuisance. The suit seeks damages for personal injury, diminution of property value, medical monitoring and other alleged real and personal property damage associated with groundwater, surface water and soil contamination found at the site of a former Merck subsidiary in Merced, California. Certain of the other defendants in this suit have settled with plaintiffs regarding some or all aspects of plaintiffs claims. This lawsuit is proceeding in a phased manner. A jury trial commenced in February 2011 during which a jury was asked to make certain factual findings regarding whether contamination moved off-site to any areas where plaintiffs could have been exposed to such contamination and, if so, when, where and in what amounts. Defendants in this Phase 1 trial included Merck and three of the other original 12 defendants. In March 2011, the Phase 1 jury returned a mixed verdict, finding in favor of Merck and the other defendants as to some, but not all, of plaintiffs claims. Specifically, the jury found that contamination from the site did not enter or affect plaintiffs municipal water supply wells or any private domestic wells. The jury found, however, that plaintiffs could have been exposed to contamination via air emissions prior to 1994, as well as via surface water in the form of storm drainage channeled into an adjacent irrigation canal, including during a flood in April 2006. In response to post-trial motions by Merck and other defendants, on September 7, 2011, the court entered an order setting aside a part of the Phase 1 jury s findings that had been in favor of plaintiffs. Specifically, the court held that plaintiffs could not have been exposed to any contamination in surface or flood water during the April 2006 flood or, in fact, at any time later than 1991. Merck s motion for reconsideration of the remainder of the jury s Phase I verdict that was adverse to Merck was denied. The court has dismissed the claims of 1,083 of the plaintiffs in this action whose claims were precluded by aspects of the Phase I jury findings and the court s subsequent orders. Subject to the court s anticipated rulings on defendants potentially dispositive summary judgment and other pre-trial motions, trial of nine selected trial plaintiffs claims currently is anticipated to begin near the end of June 2013.

Other Litigation

There are various other pending legal proceedings involving the Company, principally product liability and intellectual property lawsuits. While it is not feasible to predict the outcome of such proceedings, in the opinion of the Company, either the likelihood of loss is remote or any reasonably possible loss associated with the resolution of such proceedings is not expected to be material to the Company s financial position, results of operations or cash flows either individually or in the aggregate.

Legal Defense Reserves

Legal defense costs expected to be incurred in connection with a loss contingency are accrued when probable and reasonably estimable. Some of the significant factors considered in the review of these legal defense reserves are as follows: the actual costs incurred by the Company; the development of the Company s legal defense strategy and structure in light of the scope of its litigation; the number of cases being brought against the Company; the costs and outcomes of completed trials and the most current information regarding anticipated timing, progression, and related costs of pre-trial activities and trials in the associated litigation. The amount of legal defense reserves as of March 31, 2013 and December 31, 2012 of approximately $230 million and $260 million, respectively, represents the Company s best estimate of the minimum amount of defense costs to be incurred in connection with its outstanding litigation; however, events such as additional trials and other events that could arise in the course of its litigation could affect the ultimate amount of legal defense costs to be incurred by the Company. The Company will continue to monitor its legal defense costs and review the adequacy of the associated reserves and may determine to increase the reserves at any time in the future if, based upon the factors set forth, it believes it would be appropriate to do so.

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

9. Equity

($ and shares in millions)	Common Stock Shares	Common Stock Par Value	Other Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock Shares	Treasury Stock Cost	Non-Controlling Interests	Total
Balance January 1, 2012	3,577	$ 1,788	$ 40,663	$ 38,990	$ (3,132)	536	$ (23,792)	$ 2,426	$ 56,943
Net income attributable to Merck & Co., Inc.				1,738					1,738
Cash dividends declared on common stock				(1,287)					(1,287)
Treasury stock shares purchased						12	(456)		(456)
Share-based compensation plans and other			(11)			(13)	444		433
Other comprehensive loss					(85)				(85)
Net income attributable to noncontrolling interests								29	29
Distributions attributable to noncontrolling interests								(1)	(1)
Balance March 31, 2012	3,577	$ 1,788	$ 40,652	$ 39,441	$ (3,217)	535	$ (23,804)	$ 2,454	$ 57,314
Balance January 1, 2013	3,577	$ 1,788	$ 40,646	$ 39,985	$ (4,682)	550	$ (24,717)	$ 2,443	$ 55,463
Net income attributable to Merck & Co., Inc.				1,593					1,593
Cash dividends declared on common stock				(1,306)					(1,306)
Treasury stock shares purchased						14	(580)		(580)
Share-based compensation plans and other			(35)			(4)	168		133
Other comprehensive income					53				53
Supera joint venture			116					112	228
Net income attributable to noncontrolling interests								23	23
Distributions attributable to noncontrolling interests								(1)	(1)
Balance March 31, 2013	3,577	$ 1,788	$ 40,727	$ 40,272	$ (4,629)	560	$ (25,129)	$ 2,577	$ 55,606

In connection with the 1998 restructuring of Astra Merck Inc., the Company assumed $2.4 billion par value preferred stock with a dividend rate of 5% per annum, which is carried by KBI and included in *Noncontrolling interests* on the Consolidated Balance Sheet. If AstraZeneca exercises its option to acquire Merck s interest in AZLP (see Note 7), this preferred stock obligation will be retired.

10. Share-Based Compensation Plans

The Company has share-based compensation plans under which the Company grants restricted stock units (RSUs) and performance share units (PSUs) to certain management level employees. In addition, employees, non-employee directors and employees of certain of the Company s equity method investees may be granted options to purchase shares of Company common stock at the fair market value at the time of grant.

The following table provides amounts of share-based compensation cost recorded in the Consolidated Statement of Income:

($ in millions)	Three Months Ended March 31 2013	2012
Pretax share-based compensation expense	$ 67	$ 76
Income tax benefit	(20)	(24)
Total share-based compensation expense, net of taxes	$ 47	$ 52

During the first three months of 2013 and 2012, the Company granted 32 thousand RSUs with a weighted-average grant date fair value of $41.09 per RSU and 33 thousand RSUs with a weighted-average grant date fair value of $38.63 per RSU, respectively.

During the first three months of 2013, the Company did not grant any stock options. During the first three months of 2012, the Company granted 19 thousand options with a weighted-average exercise price of $38.63 per option. The weighted-average fair value of options granted for the first three months of 2012 was $5.17 per option and was determined using the following assumptions:

	Three Months Ended March 31, 2012
Expected dividend yield	4.4%
Risk-free interest rate	1.4%
Expected volatility	24.6%
Expected life (years)	7.0

At March 31, 2013, there was $636 million of total pretax unrecognized compensation expense related to nonvested stock options, RSU and PSU awards which will be recognized over a weighted-average period of 2.3 years.

The Company typically communicates the value of annual share-based compensation awards to employees during the first quarter, but the related share amounts are not established and communicated until early May. Therefore, while the number of RSU and stock option grants disclosed above do not reflect any amounts relating to the annual grants, share-based compensation costs for the first quarter of 2013 and 2012 and unrecognized compensation expense at March 31, 2013 reflect an impact relating to the awards communicated to employees. For segment reporting, share-based compensation costs are unallocated expenses.

11. Pension and Other Postretirement Benefit Plans

The Company has defined benefit pension plans covering eligible employees in the United States and in certain of its international subsidiaries. The net cost of such plans consisted of the following components:

	Three Months Ended March 31,	
($ in millions)	2013	2012
Service cost	$ 175	$ 142
Interest cost	166	166
Expected return on plan assets	(275)	(244)
Net amortization	84	48
Termination benefits	2	5
	$ 152	$ 117

The Company provides medical benefits, principally to its eligible U.S. retirees and similar benefits to their dependents, through its other postretirement benefit plans. The net cost of such plans consisted of the following components:

	Three Months Ended March 31,	
($ in millions)	2013	2012
Service cost	$ 24	$ 21
Interest cost	27	31
Expected return on plan assets	(31)	(34)
Net amortization	(12)	(8)
Termination benefits		2
Curtailments		(2)
	$ 8	$ 10

In connection with restructuring actions (see Note 2), termination charges were recorded on pension and other postretirement benefit plans related to expanded eligibility for certain employees exiting Merck. Also, in connection with these restructuring actions, curtailments were recorded on other postretirement benefit plans as reflected in the tables above.

12. Other (Income) Expense, Net

Other (income) expense, net, consisted of:

($ in millions)	Three Months Ended March 31, 2013	2012
Interest income	$ (57)	$ (55)
Interest expense	184	175
Exchange losses	212	67
Other, net	(57)	(45)
	$ 282	$ 142

The higher exchange losses in the first quarter of 2013 as compared with the first quarter of 2012 are due primarily to a Venezuelan currency devaluation. In February 2013, the Venezuelan government devalued its currency (Bolívar Fuertes) from 4.30 VEF per U.S. dollar to 6.30 VEF per U.S. dollar. The Company recognized losses due to exchange of approximately $140 million in the first quarter of 2013 resulting from the remeasurement of the local monetary assets and liabilities at the new rate. Since January 2010, Venezuela has been designated hyperinflationary and, as a result, local foreign operations are remeasured in U.S. dollars with the impact recorded in results of operations.

Interest paid for the three months ended March 31, 2013 and 2012 was $211 million and $187 million, respectively, which excludes commitment fees.

13. Taxes on Income

The effective income tax rates of (4.3)% and 29.5% for the first quarter of 2013 and 2012, respectively, reflect the impacts of acquisition-related costs and restructuring costs, partially offset by the beneficial impact of foreign earnings. In addition, the effective tax rate in the first quarter of 2013 reflects the favorable impact of various discrete items, including the impact of tax legislation enacted in the first quarter of 2013 that extended the R&D tax credit for both 2012 and 2013, a reduction in tax reserves upon expiration of applicable statute of limitations, as well as a benefit of approximately $160 million associated with the resolution of a previously disclosed legacy Schering-Plough federal income tax issue as discussed below.

In 2010, the Internal Revenue Service (the IRS) finalized its examination of Schering-Plough s 2003-2006 tax years. In this audit cycle, the Company reached an agreement with the IRS on an adjustment to income related to intercompany pricing matters. This income adjustment mostly reduced net operating loss carryforwards and other tax credit carryforwards. The Company s reserves for uncertain tax positions were adequate to cover all adjustments related to this examination period. Additionally, as previously disclosed, the Company was seeking resolution of one issue raised during this examination through the IRS administrative appeals process. In the first quarter of 2013, the Company recorded an out-of-period net tax benefit of $160 million related to this issue, which was settled in the fourth quarter of 2012, with final resolution relating to interest owed being reached in the first quarter of 2013. The Company s unrecognized tax benefits related to this issue exceeded the settlement amount. Management has concluded that the exclusion of this benefit is not material to prior period financial statements or projected current year financial results. The IRS began its examination of the 2007-2009 tax years in 2010.

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

14. Earnings Per Share

Prior to 2013, the Company calculated earnings per share pursuant to the two-class method under which all earnings (distributed and undistributed) are allocated to common shares and participating securities based on their respective rights to receive dividends. RSUs and certain PSUs granted before December 31, 2009 (which generally have a three year vesting period) to certain management level employees met the definition of participating securities. RSUs and PSUs issued on or after January 1, 2010 do not meet the definition of participating securities; therefore, beginning in 2013 the Company no longer applies the two-class method.

The calculations of earnings per share are as follows:

	Three Months Ended March 31,	
($ and shares in millions except per share amounts)	2013	2012
Basic Earnings per Common Share		
Net income attributable to Merck & Co., Inc.	$ 1,593	$ 1,738
Less: Income allocated to participating securities		2
Net income allocated to common shareholders	$ 1,593	$ 1,736
Average common shares outstanding	3,022	3,043
	$ 0.53	$ 0.57
Earnings per Common Share Assuming Dilution		
Net income attributable to Merck & Co., Inc.	$ 1,593	$ 1,738
Less: Income allocated to participating securities		2
Net income allocated to common shareholders	$ 1,593	$ 1,736
Average common shares outstanding	3,022	3,043
Common shares issuable [(1)]	31	31
Average common shares outstanding assuming dilution	3,053	3,074
	$ 0.52	$ 0.56

[(1)] *Issuable primarily under share-based compensation plans.*

For the three months ended March 31, 2013 and 2012, 86 million and 117 million, respectively, of common shares issuable under share-based compensation plans were excluded from the computation of earnings per common share assuming dilution because the effect would have been antidilutive.

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

15. Other Comprehensive Income (Loss)

In the first quarter of 2013, the Company prospectively adopted guidance issued by the FASB that requires additional disclosure related to the impact of reclassification adjustments out of *AOCI* on net income. Changes in *AOCI* by component are as follows:

($ in millions)	Derivatives	Investments	Employee Benefit Plans	Cumulative Translation Adjustment	Other Comprehensive Income (Loss)
Balance January 1, 2012, net of taxes	$ 4	$ 21	$ (2,346)	$ (811)	$ (3,132)
Other comprehensive income (loss), net of taxes	(58)	29		(56)	(85)
Balance March 31, 2012, net of taxes	$ (54)	$ 50	$ (2,346)	$ (867)	$ (3,217)
Balance January 1, 2013, net of taxes	$ (97)	$ 73			