Merck & Co., Inc.
Form 10-Q
August 07, 2018

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

FORM 10-Q

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

For the quarterly period ended June 30, 2018
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.
2000 Galloping Hill Road
Kenilworth, N.J. 07033
(908) 740-4000
Incorporated in New Jersey I.R.S. Employer
Identification No. 22-1918501
The number of shares of common stock outstanding as of the close of business on July 31, 2018: 2,659,525,311
Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and “emerging growth company” in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer Accelerated filer

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

Emerging growth company
If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Sales	$10,465	$9,930	$20,502	$19,365
Costs, Expenses and Other				
Materials and production	3,417	3,116	6,601	6,165
Marketing and administrative	2,508	2,500	5,016	4,972
Research and development	2,274	1,782	5,470	3,612
Restructuring costs	228	166	323	317
Other (income) expense, net	(48)	(73)	(340)	(143)
	8,379	7,491	17,070	14,923
Income Before Taxes	2,086	2,439	3,432	4,442
Taxes on Income	370	488	975	935
Net Income	1,716	1,951	2,457	3,507
Less: Net Income Attributable to Noncontrolling Interests	9	5	14	11
Net Income Attributable to Merck & Co., Inc.	$1,707	$1,946	$2,443	$3,496
Basic Earnings per Common Share Attributable to Merck & Co., Inc. Common Shareholders	$0.64	$0.71	$0.91	$1.28
Earnings per Common Share Assuming Dilution Attributable to Merck & Co., Inc. Common Shareholders	$0.63	$0.71	$0.90	$1.27
Dividends Declared per Common Share	$0.48	$0.47	$0.96	$0.94

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Net Income Attributable to Merck & Co., Inc.	$1,707	$1,946	$2,443	$3,496
Other Comprehensive Income (Loss) Net of Taxes:				
Net unrealized gain (loss) on derivatives, net of reclassifications	266	(143)	196	(375)
Net unrealized gain (loss) on investments, net of reclassifications	3	35	(96)	78
Benefit plan net gain and prior service credit, net of amortization	30	47	66	73
Cumulative translation adjustment	(361)	47	(104)	356
	(62)	(14)	62	132
Comprehensive Income Attributable to Merck & Co., Inc.	$1,645	$1,932	$2,505	$3,628

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

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

	June 30, 2018	December 31, 2017
Assets		
Current Assets		
Cash and cash equivalents	$5,310	$6,092
Short-term investments	2,284	2,406
Accounts receivable (net of allowance for doubtful accounts of $210 in both 2018 and 2017)	7,287	6,873
Inventories (excludes inventories of $1,361 in 2018 and $1,187 in 2017 classified in Other assets - see Note 7)	5,178	5,096
Other current assets	4,005	4,299
Total current assets	24,064	24,766
Investments	10,033	12,125
Property, Plant and Equipment, at cost, net of accumulated depreciation of $16,567 in 2018 and $16,602 in 2017	12,626	12,439
Goodwill	18,274	18,284
Other Intangibles, Net	12,898	14,183
Other Assets	7,145	6,075
	$85,040	$87,872
Liabilities and Equity		
Current Liabilities		
Loans payable and current portion of long-term debt	$3,379	$3,057
Trade accounts payable	3,024	3,102
Accrued and other current liabilities	9,755	10,427
Income taxes payable	661	708
Dividends payable	1,309	1,320
Total current liabilities	18,128	18,614
Long-Term Debt	19,959	21,353
Deferred Income Taxes	2,159	2,219
Other Noncurrent Liabilities	12,028	11,117
Merck & Co., Inc. Stockholders' Equity		
Common stock, $0.50 par value		
Authorized - 6,500,000,000 shares	1,788	1,788
Issued - 3,577,103,522 shares in 2018 and 2017		
Other paid-in capital	39,741	39,902
Retained earnings	41,523	41,350
Accumulated other comprehensive loss	(5,122)	(4,910)
	77,930	78,130
Less treasury stock, at cost: 907,061,576 shares in 2018 and 880,491,914 shares in 2017	45,401	43,794
Total Merck & Co., Inc. stockholders' equity	32,529	34,336
Noncontrolling Interests	237	233
Total equity	32,766	34,569
	$85,040	$87,872

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

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

	Six Months Ended June 30,	
	2018	2017
Cash Flows from Operating Activities		
Net income	$2,457	$3,507
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,363	2,355
Intangible asset impairment charges	—	131
Charge for future payments related to Eisai collaboration license options	650	—
Deferred income taxes	(258)	(272)
Share-based compensation	170	156
Other	429	63
Net changes in assets and liabilities	(1,274)	(2,337)
Net Cash Provided by Operating Activities	4,537	3,603
Cash Flows from Investing Activities		
Capital expenditures	(1,033)	(732)
Purchases of securities and other investments	(5,248)	(6,280)
Proceeds from sales of securities and other investments	7,403	9,363
Other acquisitions, net of cash acquired	(372)	(347)
Other	(274)	62
Net Cash Provided by Investing Activities	476	2,066
Cash Flows from Financing Activities		
Net change in short-term borrowings	2,069	(24)
Payments on debt	(3,008)	(301)
Purchases of treasury stock	(2,162)	(2,153)
Dividends paid to stockholders	(2,610)	(2,601)
Proceeds from exercise of stock options	299	408
Other	(277)	(86)
Net Cash Used in Financing Activities	(5,689)	(4,757)
Effect of Exchange Rate Changes on Cash, Cash Equivalents and Restricted Cash	(108)	359
Net (Decrease) Increase in Cash, Cash Equivalents and Restricted Cash	(784)	1,271
Cash, Cash Equivalents and Restricted Cash at Beginning of Year (includes restricted cash of $4 million at January 1, 2018 included in Other Assets)	6,096	6,515
Cash, Cash Equivalents and Restricted Cash at End of Period (includes restricted cash of $2 million at June 30, 2018 included in Other Assets)	$5,312	$7,786

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

Notes to Condensed Consolidated Financial Statements (unaudited)

1. Basis of Presentation

The accompanying unaudited condensed 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 27, 2018.

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 statement of these interim statements have been included and are of a normal and recurring nature. Certain reclassifications have been made to prior year amounts to conform to the current presentation.

Recently Adopted Accounting Standards

In May 2014, the Financial Accounting Standards Board (FASB) issued amended accounting guidance on revenue recognition (ASU 2014-09) that applies to all contracts with customers. The objective of the new guidance is to improve comparability of revenue recognition practices across entities and to provide more useful information to users of financial statements through improved disclosure requirements. The new standard permits two methods of adoption: retrospectively to each prior reporting period presented (full retrospective method), or retrospectively with the cumulative effect of adopting the guidance being recognized at the date of initial application (modified retrospective method). The new standard was effective as of January 1, 2018 and was adopted using the modified retrospective method. The Company recorded a cumulative-effect adjustment upon adoption increasing Retained earnings by $5 million. See Note 2 for additional information related to the adoption of this standard.

In January 2016, the FASB issued revised guidance for the accounting and reporting of financial instruments (ASU 2016-01) and in 2018 issued related technical corrections (ASU 2018-03). The new guidance requires that equity investments with readily determinable fair values currently classified as available for sale be measured at fair value with changes in fair value recognized in net income. The Company has elected to measure equity investments without readily determinable fair values at cost, less impairment, adjusted for subsequent observable price changes, which will be recognized in net income. The new guidance also changed certain disclosure requirements. ASU 2016-01 was effective as of January 1, 2018 and was adopted using a modified retrospective approach. The Company recorded a cumulative-effect adjustment upon adoption increasing Retained earnings by $8 million. ASU 2018-03 was also adopted as of January 1, 2018 on a prospective basis and did not result in any additional impacts upon adoption.

In October 2016, the FASB issued guidance on the accounting for the income tax consequences of intra-entity transfers of assets other than inventory (ASU 2016-16). The new guidance requires the recognition of the income tax consequences of an intra-entity transfer of an asset (with the exception of inventory) when the intra-entity transfer occurs, replacing the prohibition against doing so. The current exception to defer the recognition of any tax impact on the transfer of inventory within the consolidated entity until it is sold to a third party remains unaffected. The new standard was effective as of January 1, 2018 and was adopted using a modified retrospective approach. The Company recorded a cumulative-effect adjustment upon adoption increasing Retained earnings by $54 million with a corresponding decrease to Deferred Income Taxes.

In August 2017, the FASB issued new guidance on hedge accounting (ASU 2017-12) that is intended to more closely align hedge accounting with companies' risk management strategies, simplify the application of hedge accounting, and increase transparency as to the scope and results of hedging programs. The new guidance makes more financial and nonfinancial hedging strategies eligible for hedge accounting, amends the presentation and disclosure requirements, and changes how companies assess effectiveness. The Company elected to early adopt this guidance as of January 1, 2018 on a modified retrospective basis. The new guidance was applied to all existing hedges as of the adoption date. For fair value hedges of interest rate risk outstanding as of the date of adoption, the Company recorded a cumulative-effect adjustment upon adoption to the basis adjustment on the hedged item resulting from applying the benchmark component of the coupon guidance. This adjustment decreased Retained earnings by $11 million. Also, in accordance with the transition provisions of ASU 2017-12, the Company was required to eliminate the separate measurement of ineffectiveness for its cash flow hedging instruments existing as of the adoption date through a cumulative-effect adjustment to retained earnings; however, all such amounts were de minimis.

In February 2018, the FASB issued new guidance to address a narrow-scope financial reporting issue that arose as a consequence of the Tax Cuts and Jobs Act (TCJA) (ASU 2018-02). Existing guidance requires that deferred tax liabilities and assets be adjusted for a change in tax laws or rates with the effect included in income from continuing operations in the reporting period that includes the enactment date. That guidance is applicable even in situations in which the related income tax effects of items in accumulated other comprehensive income were originally recognized in other comprehensive income (rather than in net income), such as amounts related to benefit plans and hedging activity. As a result, the tax effects of items within accumulated other comprehensive income do not reflect the appropriate tax rate (the difference is referred to as stranded tax effects). The new guidance allows for a reclassification of these amounts to retained earnings thereby eliminating these stranded tax effects. The Company elected to early adopt the new guidance in the first quarter of 2018 and reclassified the stranded income tax effects of

Notes to Condensed Consolidated Financial Statements (unaudited)

the TCJA increasing Accumulated other comprehensive loss in the provisional amount of $266 million with a corresponding increase to Retained earnings (see Note 15). The Company's policy for releasing disproportionate income tax effects from Accumulated other comprehensive loss is to utilize the item-by-item approach.

The impact of adopting the above standards is as follows:

($ in millions)	ASU 2014-09 (Revenue)	ASU 2016-01 (Financial Instruments)	ASU 2016-16 (Intra-Entity Transfers of Assets Other than Inventory)	ASU 2017-12 (Derivatives and Hedging)	ASU 2018-02 (Reclassification of Certain Tax Effects)	Total
Assets - Increase (Decrease)						
Accounts receivable	$ 5					$ 5
Liabilities - Increase (Decrease)						
Income Taxes Payable				(3)		(3)
Debt				14		14
Deferred Income Taxes			(54)			(54)
Equity - Increase (Decrease)						
Retained earnings	5	8	54	(11)	266	322
Accumulated other comprehensive loss		(8)			(266)	(274)

In March 2017, the FASB amended the guidance related to net periodic benefit cost for defined benefit plans that requires entities to (1) disaggregate the current service cost component from the other components of net benefit cost and present it with other employee compensation costs in the income statement within operations if such a subtotal is presented; (2) present the other components of net benefit cost separately in the income statement and outside of income from operations; and (3) only capitalize the service cost component when applicable. The Company adopted the new standard as of January 1, 2018 using a retrospective transition method as to the requirement for separate presentation in the income statement of service costs and other components and a prospective transition method as to the requirement to limit the capitalization of benefit costs to the service cost component. The Company utilized a practical expedient that permits it to use the amounts disclosed in its pension and other postretirement benefit plan note for the prior comparative periods as the estimation basis for applying the retrospective presentation requirements. Upon adoption, net periodic benefit cost (credit) other than service cost was reclassified to Other (income) expense, net from the previous classification within Materials and production costs, Marketing and administrative expenses and Research and development costs (see Note 12).

In August 2016, the FASB issued guidance on the classification of certain cash receipts and payments in the statement of cash flows intended to reduce diversity in practice. The Company adopted the new standard effective as of January 1, 2018 using a retrospective application. There were no changes to the presentation of the Consolidated Statement of Cash Flows in the prior year period as a result of adopting the new standard.

In November 2016, the FASB issued guidance requiring that amounts generally described as restricted cash and restricted cash equivalents be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The new standard was effective as of January 1, 2018 and was adopted using a retrospective application. The adoption of the new guidance did not have a material effect on the Company's Consolidated Statement of Cash Flows.

In May 2017, the FASB issued guidance clarifying when to account for a change to the terms or conditions of a share-based payment award as a modification. Under the new guidance, modification accounting is required only if the fair value, the vesting conditions, or the classification of the award (as equity or liability) changes as a result of the change in terms or conditions. The Company adopted the new standard effective as of January 1, 2018 and will apply the new guidance to future share-based payment award modifications should they occur.

Recently Issued Accounting Standards Not Yet Adopted

In February 2016, the FASB issued new accounting guidance for the accounting and reporting of leases. The new guidance requires that lessees recognize a right-of-use asset and a lease liability recorded on the balance sheet for each of its leases (other than leases that meet the definition of a short-term lease). Leases will be classified as either operating or finance. Operating leases will result in straight-line expense in the income statement (similar to current operating leases) while finance leases will result in more expense being recognized in the earlier years of the lease term (similar to current capital leases). The new guidance will be effective for interim and annual periods beginning in 2019 and will be adopted using a modified retrospective approach. The Company intends to elect available practical expedients. The Company is currently evaluating the impact of adoption on its consolidated financial statements.

Notes to Condensed Consolidated Financial Statements (unaudited)

In June 2016, the FASB issued amended guidance on the accounting for credit losses on financial instruments. The guidance introduces an expected loss model for estimating credit losses, replacing the incurred loss model. The new guidance also changes the impairment model for available-for-sale debt securities, requiring the use of an allowance to record estimated credit losses (and subsequent recoveries). The new guidance is effective for interim and annual periods beginning in 2020, with earlier application permitted in 2019. The new guidance is to be applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings in the beginning of the period of adoption. The Company is currently evaluating the impact of adoption on its consolidated financial statements.

In January 2017, the FASB issued guidance that provides for the elimination of Step 2 from the goodwill impairment test. Under the new guidance, impairment charges are recognized to the extent the carrying amount of a reporting unit exceeds its fair value with certain limitations. The new guidance is effective for interim and annual periods in 2020. Early adoption is permitted. The Company does not anticipate that the adoption of the new guidance will have a material effect on its consolidated financial statements.

2. Summary of Significant Accounting Policies

On January 1, 2018, the Company adopted ASU 2014-09, Revenue from Contracts with Customers, and subsequent amendments (ASC 606 or new guidance), using the modified retrospective method. Merck applied the new guidance to all contracts with customers within the scope of the standard that were in effect on January 1, 2018 and recognized the cumulative effect of initially applying the new guidance as an adjustment to the opening balance of retained earnings (see Note 1). Comparative information for prior periods has not been restated and continues to be reported under the accounting standards in effect for those periods.

The new guidance provides principles that an entity applies to report useful information about the amount, timing, and uncertainty of revenue and cash flows arising from its contracts to provide goods or services to customers. The core principle requires an entity to recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration that it expects to be entitled to in exchange for those goods or services. The new guidance introduces a 5-step model to recognize revenue when or as control is transferred: identify the contract with a customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and recognize revenue when or as the performance obligations are satisfied. The Company's significant accounting policies are detailed in Note 2 to the consolidated financial statements included in Merck's Annual Report on Form 10-K for the year ended December 31, 2017. Changes to the Company's revenue recognition policy as a result of adopting ASC 606 are described below. See Note 16 for disaggregated revenue disclosures.

Revenue Recognition — Recognition of revenue requires evidence of a contract, probable collection of sales proceeds and completion of substantially all performance obligations. Merck acts as the principal in substantially all of its customer arrangements and therefore records revenue on a gross basis. The majority of the Company's contracts related to the Pharmaceutical and Animal Health segments have a single performance obligation - the promise to transfer goods. Shipping is considered immaterial in the context of the overall customer arrangement and damages or loss of goods in transit are rare. Therefore, shipping is not deemed a separately recognized performance obligation. The vast majority of revenues from sales of products are recognized at a point in time when control of the goods is transferred to the customer, which the Company has determined is when title and risks and rewards of ownership transfer to the customer and the Company is entitled to payment. Certain Merck entities, including U.S. entities, have contract terms under which control of the goods passes to the customer upon shipment; however, either pursuant to the terms of the contract or as a business practice, Merck retains responsibility for goods lost or damaged in transit. Prior to the adoption of the new standard, Merck would recognize revenue for these entities upon delivery of the goods. Under the new guidance, the Company is now recognizing revenue at time of shipment for these entities.

For businesses within the Company's Healthcare Services segment and certain services in the Animal Health segment, revenue is recognized over time, generally ratably over the contract term as services are provided.

Merck's payment terms for U.S. pharmaceutical customers are typically net 36 days from receipt of invoice and for U.S. animal health customers are typically net 30 days from receipt of invoice; however, certain products, including Keytruda, have longer payment terms up to 90 days. Outside of the United States, payment terms are typically 30 days

to 90 days although certain markets have longer payment terms.

The nature of the Company's business gives rise to several types of variable consideration including discounts and returns, which are estimated at the time of sale generally using the expected value method, although the most likely amount method is also used for certain types of variable consideration. In the United States, sales discounts are issued to customers at the point-of-sale, through an intermediary wholesaler (known as chargebacks), or in the form of rebates. Additionally, sales are generally made with a limited right of return under certain conditions. Revenues are recorded net of provisions for sales discounts and

Notes to Condensed Consolidated Financial Statements (unaudited)

returns, which are established at the time of sale. In addition, revenues are recorded net of time value of money discounts if collection of accounts receivable is expected to be in excess of one year.

The provision for aggregate customer discounts covers chargebacks and rebates. Chargebacks are discounts that occur when a contracted customer purchases through an intermediary wholesaler. The contracted customer generally purchases product from the wholesaler at its contracted price plus a mark-up. The wholesaler, in turn, charges the Company back for the difference between the price initially paid by the wholesaler and the contract price paid to the wholesaler by the customer. The provision for chargebacks is based on expected sell-through levels by the Company's wholesale customers to contracted customers, as well as estimated wholesaler inventory levels. Rebates are amounts owed based upon definitive contractual agreements or legal requirements with private sector and public sector (Medicaid and Medicare Part D) benefit providers, after the final dispensing of the product by a pharmacy to a benefit plan participant. The provision for rebates is based on expected patient usage, as well as inventory levels in the distribution channel to determine the contractual obligation to the benefit providers. The Company uses historical customer segment utilization mix, sales forecasts, changes to product mix and price, inventory levels in the distribution channel, government pricing calculations and prior payment history in order to estimate the expected provision. Amounts accrued for aggregate customer discounts are evaluated on a quarterly basis through comparison of information provided by the wholesalers, health maintenance organizations, pharmacy benefit managers, federal and state agencies, and other customers to the amounts accrued. These discounts, in the aggregate, reduced U.S. sales by $2.8 billion in both the second quarter of 2018 and 2017, and by $5.2 billion and $5.3 billion for the first six months of 2018 and 2017, respectively.

Outside of the United States, variable consideration in the form of discounts and rebates are a combination of commercially-driven discounts in highly competitive product classes, discounts required to gain or maintain reimbursement, or legislatively mandated rebates. In certain European countries, legislatively mandated rebates are calculated based on an estimate of the government's total unbudgeted spending and the Company's specific payback obligation. Rebates may also be required based on specific product sales thresholds. In all cases, the Company applies an estimated factor against its actual invoiced sales to represent the expected level of future discount or rebate obligation associated with the sale.

The Company maintains a returns policy that allows its U.S. pharmaceutical customers to return product within a specified period prior to and subsequent to the expiration date (generally, three to six months before and 12 months after product expiration). The estimate of the provision for returns is based upon historical experience with actual returns. Additionally, the Company considers factors such as levels of inventory in the distribution channel, product dating and expiration period, whether products have been discontinued, entrance in the market of generic competition, changes in formularies or launch of over-the-counter products, among others. Outside of the United States, returns are only allowed on a limited basis in certain countries.

The following table provides the effects of adopting ASC 606 on the Consolidated Statement of Income for the three and six months ended June 30, 2018:

	Three Months Ended June 30, 2018			Six Months Ended June 30, 2018		
($ in millions)	As Reported	Effects of Adopting ASC 606	Amounts Without Adoption of ASC 606	As Reported	Effects of Adopting ASC 606	Amounts Without Adoption of ASC 606
Sales	$10,465	$ (6)	$ 10,459	$20,502	$ (29)	$ 20,473
Materials and production	3,417	(5)	3,412	6,601	(16)	6,585
Income before taxes	2,086	(1)	2,085	3,432	(13)	3,419
Taxes on income	370	(1)	369	975	(3)	972
Net income attributable to Merck & Co., Inc.	1,707	—	1,707	2,443	(10)	2,433

The following table provides the effects of adopting ASC 606 on the Consolidated Balance Sheet as of June 30, 2018:

($ in millions)	June 30, 2018		
	As Reported	Effects of Adopting ASC 606	Amounts Without Adoption of ASC 606
Assets			
Accounts receivable	$7,287	$ (47)	$ 7,240
Inventories	5,178	18	5,196
Liabilities			
Accrued and other current liabilities	9,755	(9)	9,746
Income taxes payable	661	(5)	656
Equity			
Retained earnings	41,523	(15)	41,508

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

3. Acquisitions, Divestitures, Research Collaborations and License Agreements

The Company continues to pursue the acquisition of businesses and establishment of external alliances such as research collaborations and licensing agreements to complement its internal research capabilities. These arrangements often include upfront payments, as well as expense reimbursements or payments to the third party, and milestone, royalty or profit share arrangements, contingent upon the occurrence of certain future events linked to the success of the asset in development. The Company also reviews its marketed products and pipeline to examine candidates which may provide more value through out-licensing and, as part of its portfolio assessment process, may also divest certain assets. Pro forma financial information for acquired businesses is not presented if the historical financial results of the acquired entity are not significant when compared with the Company's financial results.

In June 2018, Merck acquired Viralytics Limited (Viralytics), an Australian publicly traded company focused on oncolytic immunotherapy treatments for a range of cancers, for AUD 502 million ($378 million). The transaction provided Merck with full rights to Cavatak (V937, formerly CVA21), Viralytics's investigational oncolytic immunotherapy. Cavatak is based on Viralytics's proprietary formulation of an oncolytic virus (Coxsackievirus Type A21) that has been shown to preferentially infect and kill cancer cells. Cavatak is currently being evaluated in multiple Phase 1 and Phase 2 clinical trials, both as an intratumoral and intravenous agent, including in combination with Keytruda. Under a previous agreement between Merck and Viralytics, a study is investigating the use of the Keytruda and Cavatak combination in melanoma, prostate, lung and bladder cancers. The transaction was accounted for as an asset acquisition. Merck recorded net assets of $34 million (primarily cash) at the acquisition date and Research and development expenses of $344 million for the second quarter and first six months of 2018 related to the transaction. There are no future contingent payments associated with the acquisition.

In April 2018, Merck sold C3i Solutions, a multi-channel customer engagement services provider which was part of the Healthcare Services segment, to HCL Technologies Limited for $65 million. The transaction resulted in a loss of $11 million recorded in Other (income) expense, net.

In March 2018, Merck and Eisai Co., Ltd. (Eisai) entered into a strategic collaboration for the worldwide co-development and co-commercialization of Lenvima, an orally available tyrosine kinase inhibitor discovered by Eisai (see Note 4).

In July 2017, Merck and AstraZeneca PLC (AstraZeneca) entered into a global strategic oncology collaboration to co-develop and co-commercialize AstraZeneca's Lynparza for multiple cancer types (see Note 4).

In March 2017, Merck acquired a controlling interest in Vallée S.A. (Vallée), a leading privately held producer of animal health products in Brazil. Vallée has an extensive portfolio of products spanning parasiticides, anti-infectives and vaccines that include products for livestock, horses, and companion animals. Under the terms of the agreement, Merck acquired 93.5% of the shares of Vallée for $358 million. Of the total purchase price, $176 million was placed into escrow pending resolution of certain contingent items. The transaction was accounted for as an acquisition of a business. Merck recognized intangible assets of $297 million related to currently marketed products, net deferred tax liabilities of $102 million, other net assets of $32 million and noncontrolling interest of $25 million. In addition, the Company recorded liabilities of $37 million for contingencies identified at the acquisition date and corresponding indemnification assets of $37 million, representing the amounts to be reimbursed to Merck if and when the contingent liabilities are paid. The excess of the consideration transferred over the fair value of net assets acquired of $156 million was recorded as goodwill. The goodwill was allocated to the Animal Health segment and is not deductible for tax purposes. The estimated fair values of identifiable intangible assets related to currently marketed products were determined using an income approach. The probability-adjusted future net cash flows of each product were discounted to present value utilizing a discount rate of 15.5%. Actual cash flows are likely to be different than those assumed. The intangible assets related to currently marketed products are being amortized over their estimated useful lives of 15 years. In the fourth quarter of 2017, Merck acquired an additional 4.5% interest in Vallée for $18 million, which reduced the noncontrolling interest related to Vallée.

4. Collaborative Arrangements

Merck has entered into collaborative arrangements that provide the Company with varying rights to develop, produce and market products together with its collaborative partners. Both parties in these arrangements are active participants and exposed to significant risks and rewards dependent on the commercial success of the activities of the

collaboration. Merck's more significant collaborative arrangements are discussed below.

AstraZeneca

In July 2017, Merck and AstraZeneca entered into a global strategic oncology collaboration to co-develop and co-commercialize AstraZeneca's Lynparza for multiple cancer types. Lynparza is an oral poly (ADP-ribose) polymerase (PARP) inhibitor currently approved for certain types of ovarian and breast cancer. The companies are jointly developing and commercializing Lynparza, both as monotherapy and in combination trials with other potential medicines. Independently, Merck and AstraZeneca will develop and commercialize Lynparza in combinations with their respective PD-1 and PD-L1 medicines, Keytruda and Imfinzi. The companies will also jointly develop and commercialize AstraZeneca's selumetinib, an oral, potent,

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

selective inhibitor of MEK, part of the mitogen-activated protein kinase (MAPK) pathway, currently being developed for multiple indications. Under the terms of the agreement, AstraZeneca and Merck will share the development and commercialization costs for Lynparza and selumetinib monotherapy and non-PD-L1/PD-1 combination therapy opportunities.

Gross profits from Lynparza and selumetinib product sales generated through monotherapies or combination therapies are shared equally. Merck will fund all development and commercialization costs of Keytruda in combination with Lynparza or selumetinib. AstraZeneca will fund all development and commercialization costs of Imfinzi in combination with Lynparza or selumetinib. AstraZeneca is currently the principal on Lynparza sales transactions. Merck is recording its share of Lynparza product sales, net of cost of sales and commercialization costs, as alliance revenue within the Pharmaceutical segment and its share of development costs associated with the collaboration as part of Research and development expenses. Reimbursements received from AstraZeneca for research and development expenses are recognized as reductions to Research and development costs.

As part of the agreement, Merck made an upfront payment to AstraZeneca of $1.6 billion and is making payments totaling $750 million over a multi-year period for certain license options ($250 million of which was paid in 2017). The Company recorded an aggregate charge of $2.35 billion in Research and development expenses in 2017 related to the upfront payment and future license options payments. In addition, the agreement provides for additional contingent payments from Merck to AstraZeneca of up to $6.15 billion, of which $2.05 billion relate to the successful achievement of regulatory milestones and $4.1 billion relate to the achievement of sales milestones for total aggregate consideration of up to $8.5 billion.

In the second quarter of 2018, Merck determined it was probable that annual sales of Lynparza in the future would trigger a $200 million sales-based milestone payment from Merck to AstraZeneca. Accordingly, in the second quarter of 2018, Merck recorded a $200 million noncurrent liability and a corresponding intangible asset and also recognized $17 million of cumulative amortization expense within Materials and production costs. The remaining intangible asset will be amortized over its estimated useful life of approximately 10 years as supported by projected future cash flows, subject to impairment testing. Merck previously accrued a $150 million sales-based milestone in the first quarter of 2018 (along with $9 million of cumulative amortization expense) and a $100 million sales-based milestone in 2017. The remaining $3.65 billion of potential future sales-based milestone payments have not yet been accrued as they are not deemed by the Company to be probable at this time.

In January 2018, Lynparza received approval in the United States for the treatment of certain patients with metastatic breast cancer, triggering a $70 million milestone payment from Merck to AstraZeneca. This milestone payment was capitalized and will be amortized over its estimated useful life, subject to impairment testing. Potential future regulatory milestone payments of $1.98 billion remain under the agreement.

Summarized information related to this collaboration is as follows:

($ in millions)	Three Months Ended June 30, 2018	Six Months Ended June 30, 2018
Alliance revenues	$ 44	$ 76
Materials and production [1]	24	36
Marketing and administrative	9	16
Research and development	42	71

($ in millions)	June 30, 2018	December 31, 2017
Receivables from AstraZeneca	$ 40	$ 12
Payables to AstraZeneca [2]	990	643

(1) Represents amortization of intangible assets.
(2) Includes accrued milestone and license option payments.

Eisai

In March 2018, Merck and Eisai announced a strategic collaboration for the worldwide co-development and co-commercialization of Lenvima, an orally available tyrosine kinase inhibitor discovered by Eisai. Under the agreement, Merck and Eisai will develop and commercialize Lenvima jointly, both as monotherapy and in combination with Merck's anti-PD-1 therapy, Keytruda. Eisai records Lenvima product sales globally (Eisai is the principal on Lynparza sales transactions), and Merck and Eisai share gross profits equally. Merck records its share of Lenvima product sales net of cost of sales and commercialization costs, as alliance revenue. Expenses incurred during co-development, including for studies evaluating Lenvima as monotherapy, are shared equally by the two companies. Under the agreement, Merck made upfront payments to Eisai of $750 million and will make payments of up to $650 million for certain option rights through 2021 ($325 million in January 2019 or earlier in certain

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

circumstances, $200 million in January 2020 and $125 million in January 2021). The Company recorded an aggregate charge of $1.4 billion in Research and development expenses in the first six months of 2018 related to the upfront payments and future option payments. In addition, the agreement provides for Eisai to receive up to $385 million in the future associated with the achievement of certain clinical and regulatory milestones and up to $3.97 billion for the achievement of milestones associated with sales of Lenvima. In March 2018, Lenvima was approved in Japan for unresectable hepatocellular carcinoma, which was the first regulatory approval under the global strategic collaboration, triggering a $25 million milestone payment to Eisai. This milestone payment was capitalized and will be amortized over its estimated useful life of approximately nine years, subject to impairment testing.
Summarized information related to this collaboration is as follows:

($ in millions)	Three Months Ended June 30, 2018
Alliance revenues	$ 35
Materials and production [1]	1
Marketing and administrative	2
Research and development	36

($ in millions)	June 30, 2018
Receivables from Eisai	$ 35
Payables to Eisai [2]	677

[1] Represents amortization of intangible assets.
[2] Includes accrued license option payments.

Bayer AG

In 2014, the Company entered into a worldwide clinical development collaboration with Bayer AG (Bayer) to market and develop soluble guanylate cyclase (sGC) modulators including Bayer's Adempas, which is approved to treat pulmonary arterial hypertension and chronic thromboembolic pulmonary hypertension. The two companies have implemented a joint development and commercialization strategy. The collaboration also includes clinical development of Bayer's vericiguat, which is in Phase 3 trials for worsening heart failure, as well as opt-in rights for other early-stage sGC compounds in development by Bayer. Merck in turn made available its early-stage sGC compounds under similar terms. Under the agreement, Bayer leads commercialization of Adempas in the Americas, while Merck leads commercialization in the rest of the world. For vericiguat and other potential opt-in products, Bayer will lead commercialization in the rest of world and Merck will lead in the Americas. For all products and candidates included in the agreement, both companies will share in development costs and profits on sales and will have the right to co-promote in territories where they are not the lead. In 2016, Merck began promoting and distributing Adempas in Europe. Transition from Bayer in other Merck territories, including Japan, continued in 2017. Revenue from Adempas includes sales in Merck's marketing territories, as well as Merck's share of profits from the sale of Adempas in Bayer's marketing territories.

In the second quarter of 2018, Merck determined it was probable that annual sales of Adempas in the future would trigger a $375 million sales-based milestone payment from Merck to Bayer. Accordingly, in the second quarter of 2018, Merck recorded a $375 million noncurrent liability and a corresponding intangible asset and also recognized $106 million of cumulative amortization expense within Materials and production costs. The remaining intangible asset will be amortized over its estimated useful life of approximately 9.5 years as supported by projected future cash flows, subject to impairment testing. In 2017, annual sales of Adempas exceeded $500 million triggering a $350 million milestone payment from Merck to Bayer, which was accrued for in 2016 when Merck deemed the payment to

be probable. The milestone was paid in the first quarter of 2018. There is an additional $400 million potential future sales-based milestone payment that has not yet been accrued as it is not deemed by the Company to be probable at this time.

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

Summarized information related to this collaboration is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
($ in millions)	2018	2017	2018	2017
Net product sales recorded by Merck	$47	$ 36	$90	$ 67
Merck’s profit share from sales in Bayer's marketing territories	28	31	53	84
Total sales	75	67	143	151
Materials and production [1]	132	24	159	47
Marketing and administrative	10	5	17	11
Research and development	28	25	56	51

($ in millions)	June 30, 2018	December 31, 2017
Receivables from Bayer	$27	$ 33
Payables to Bayer [2]	375	352

[1] Includes amortization of intangible assets.

[2] Includes accrued milestone payments.

5. Restructuring

In 2010 and 2013, the Company commenced actions under global restructuring programs designed to streamline its cost structure. The actions under these programs include the elimination of positions in sales, administrative and headquarters organizations, as well as the sale or closure of certain manufacturing and research and development sites and the consolidation of office facilities. The Company also continues to reduce its global real estate footprint and improve the efficiency of its manufacturing and supply network.

The Company recorded total pretax costs of $235 million and $210 million in the second quarter of 2018 and 2017, respectively, and $339 million and $425 million for the first six months of 2018 and 2017, respectively, related to restructuring program activities. Since inception of the programs through June 30, 2018, Merck has recorded total pretax accumulated costs of approximately $13.8 billion and eliminated approximately 44,695 positions comprised of employee separations, as well as the elimination of contractors and vacant positions. The Company estimates that approximately two-thirds of the cumulative pretax costs are 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. While the Company has substantially completed the actions under these programs, approximately $500 million of pretax costs are expected to be incurred for the full year of 2018 relating to anticipated employee separations and remaining asset-related costs.

For segment reporting, restructuring charges are unallocated expenses.

The following tables summarize the charges related to restructuring program activities by type of cost:

	Three Months Ended June 30, 2018				Six Months Ended June 30, 2018			
($ in millions)	Separation Costs	Accelerated Depreciation	Other	Total	Separation Costs	Accelerated Depreciation	Other	Total
Materials and production	$—	$ —	$ 3	$3	$—	$ —	$ 9	$9
Marketing and administrative	—	—	1	1	—	1	1	2
Research and development	—	—	3	3	—	(3)	8	5
Restructuring costs	200	—	28	228	255	—	68	323
	$200	$ —	$ 35	$235	$255	$ (2)	$ 86	$339

($ in millions)	Three Months Ended June 30, 2017				Six Months Ended June 30, 2017			
	Separation Costs	Accelerated Depreciation	Other	Total	Separation Costs	Accelerated Depreciation	Other	Total
Materials and production	$—	$ (4)	$ 37	$33	$—	$ 47	$49	$96
Marketing and administrative	—	2	—	2	—	2	1	3
Research and development	—	8	1	9	—	6	3	9
Restructuring costs	118	—	48	166	202	—	115	317
	$118	$ 6	$ 86	$210	$202	$ 55	$168	$425

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

Separation costs are associated with actual headcount reductions, as well as those headcount reductions which were probable and could be reasonably estimated. In the second quarter of 2018 and 2017, approximately 635 positions and 475 positions, respectively, and for the first six months of 2018 and 2017, 1,345 positions and 1,020 positions, respectively, were eliminated under restructuring program activities.

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 asset, based upon the anticipated date the site will be closed or divested or the equipment disposed of, 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 undiscounted cash flows were sufficient to recover the respective book values, Merck is recording accelerated depreciation over the revised useful life of the site assets. Anticipated site closure dates, particularly related to manufacturing locations, have been and may continue to be adjusted to reflect changes resulting from regulatory or other factors.

Other activity in 2018 and 2017 includes asset abandonment, shut-down and other related costs, as well as pretax gains and losses resulting from sales of facilities and related assets. Additionally, other activity includes certain employee-related costs associated with pension and other postretirement benefit plans (see Note 11) and share-based compensation.

The following table summarizes the charges and spending relating to restructuring program activities for the six months ended June 30, 2018:

($ in millions)	Separation Costs	Accelerated Depreciation	Other	Total
Restructuring reserves January 1, 2018	$ 619	$ —	$128	$747
Expense	255	(2)	86	339
(Payments) receipts, net	(389)	—	(116)	(505)
Non-cash activity	—	2	7	9
Restructuring reserves June 30, 2018 [1]	$ 485	$ —	$105	$590

[1] The remaining cash outlays are expected to be substantially completed by the end of 2020.

6. 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 variability caused by changes in foreign exchange rates that would affect 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 (forecasted sales) that are expected to occur over its planning cycle, typically no more than two years into the future. The Company will layer in hedges over time, increasing the portion of forecasted sales hedged as it gets closer to the expected date of the forecasted sales. The portion of forecasted 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 Company manages its anticipated transaction exposure principally with purchased local currency put options, forward contracts and purchased collar options.

The fair values of these derivative contracts are recorded as either assets (gain positions) or liabilities (loss positions) in the Condensed 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 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. For those derivatives which are not designated as cash flow hedges, but serve as economic

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

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 Condensed Consolidated Statement of Cash Flows. The Company does not enter into derivatives for trading or speculative purposes.

The Company manages operating activities and net asset positions at each local subsidiary in order to mitigate the effects of exchange on monetary assets and liabilities. The Company also uses a balance sheet risk management program to mitigate the exposure of net monetary assets that are denominated in a currency other than a subsidiary's functional currency from the effects of volatility in foreign exchange. In these instances, Merck principally utilizes forward exchange 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 cash flows from these contracts are reported as operating activities in the Condensed Consolidated Statement of Cash Flows.

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. The unrealized gains or losses on these contracts are recorded in foreign currency translation adjustment within OCI, and remain in AOCI until either the sale or complete or substantially complete liquidation of the subsidiary. The Company excludes certain portions of the change in fair value of its derivative instruments from the assessment of hedge effectiveness (excluded component). Changes in fair value of the excluded components are recognized in OCI. In accordance with the new guidance adopted on January 1, 2018 (see Note 1), the Company has elected to recognize in earnings the initial value of the excluded component on a straight-line basis over the life of the derivative instrument, rather than using the mark-to-market approach. The cash flows from these contracts are reported as investing activities in the Condensed 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.

The effect of the Company's net investment hedges on OCI and the Consolidated Statement of Income is shown below:

	Amount of Pretax (Gain) Loss Recognized in Other Comprehensive Income [1]				Amount of Pretax (Gain) Loss Recognized in Other (income) expense, net for Amounts Excluded from Effectiveness Testing			
	Three Months Ended June 30,		Six Months Ended June 30,		Three Months Ended June 30,		Six Months Ended June 30,	
($ in millions)	2018	2017	2018	2017	2018	2017	2018	2017

Net Investment Hedging Relationships								
Foreign exchange contracts	$(12)	$ —	$(14)	$ —	$(3)	$ —	$(3)	$ —
Euro-denominated notes	(271)	204	(92)	339	—	—	—	—

(1) No amounts were reclassified from AOCI into income related to the sale of a subsidiary.

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.

In May 2018, four interest rate swaps with notional amounts of $250 million each matured. These swaps effectively converted the Company's $1.0 billion, 1.30% fixed-rate notes due 2018 to variable rate debt. At June 30, 2018, the Company was a party to 22 pay-floating, receive-fixed interest rate swap contracts designated as fair value hedges of fixed-rate notes in which the notional amounts match the amount of the hedged fixed-rate notes as detailed in the table below.

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

($ in millions)	June 30, 2018 Par Value of Debt	Number of Interest Rate Swaps Held	Total Swap Notional Amount
5.00% notes due 2019	1,250	3	550
1.85% notes due 2020	1,250	5	1,250
3.875% notes due 2021	1,150	5	1,150
2.40% notes due 2022	1,000	4	1,000
2.35% notes due 2022	1,250	5	1,250

The interest rate swap contracts are designated hedges of the fair value changes in the notes attributable to changes in the benchmark London Interbank Offered Rate (LIBOR) swap rate. The fair value changes in the notes attributable to changes in the LIBOR swap rate are recorded in interest expense along with the offsetting fair value changes in the swap contracts. The cash flows from these contracts are reported as operating activities in the Condensed Consolidated Statement of Cash Flows.

The table below presents the location of amounts recorded on the Consolidated Balance Sheet related to cumulative basis adjustments for fair value hedges:

	Carrying Amount of Hedged Liabilities		Cumulative Amount of Fair Value Hedging Adjustment Increase (Decrease) Included in the Carrying Amount	
($ in millions)	June 30, 2018	December 31, 2017	June 30, 2018	December 31, 2017
Balance Sheet Line Item in which Hedged Item is Included				
Loans payable and current portion of long-term debt	$554	$ 983	$ 5	$ (17)
Long-Term Debt [1]	4,511	5,146	(129)	(41)

[1] Amounts include hedging adjustment gains related to discontinued hedging relationships of $7 million and $11 million at June 30, 2018 and December 31, 2017, respectively.

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

		June 30, 2018			December 31, 2017		
($ in millions)	Balance Sheet Caption	Fair Value of Derivative Asset	Fair Value of Derivative Liability	U.S. Dollar Notional	Fair Value of Derivative Asset	Fair Value of Derivative Liability	U.S. Dollar Notional
Derivatives Designated as Hedging Instruments							
Interest rate swap contracts	Other assets	$ —	$ —	$ —	$ 2	$ —	$ 550
Interest rate swap contracts	Accrued and other current liabilities	—	2	550	—	3	1,000
Interest rate swap contracts	Other noncurrent liabilities	—	130	4,650	—	52	4,650
Foreign exchange contracts	Other current assets	153	—	6,071	51	—	4,216

Foreign exchange contracts	Other assets	83	—	2,561	38	—	1,936
Foreign exchange contracts	Accrued and other current liabilities	—	8	590	—	71	2,014
Foreign exchange contracts	Other noncurrent liabilities	—	1	144	—	1	20
		$ 236	$ 141	$ 14,566	$ 91	$ 127	$ 14,386
Derivatives Not Designated as Hedging Instruments							
Foreign exchange contracts	Other current assets	$ 208	$ —	$ 6,403	$ 39	$ —	$ 3,778
Foreign exchange contracts	Accrued and other current liabilities	—	56	4,681	—	90	7,431
		$ 208	$ 56	$ 11,084	$ 39	$ 90	$ 11,209
		$ 444	$ 197	$ 25,650	$ 130	$ 217	$ 25,595

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

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

	June 30, 2018		December 31, 2017	
($ in millions)	Asset	Liability	Asset	Liability
Gross amounts recognized in the consolidated balance sheet	$444	$ 197	$130	$ 217
Gross amount subject to offset in master netting arrangements not offset in the consolidated balance sheet	(152)	(152)	(94)	(94)
Cash collateral received	(90)	—	(3)	—
Net amounts	$202	$ 45	$33	$ 123

The table below provides information regarding the location and amount of pretax (gains) losses of derivatives designated in fair value or cash flow hedging relationships:

	Sales		Other (income) expense, net [1]		Other comprehensive income (loss)		Sales		Other (income) expense, net [1]		Other comprehensive income (loss)	
	Three Months Ended June 30,		Three Months Ended June 30,		Three Months Ended June 30,		Six Months Ended June 30,		Six Months Ended June 30,		Six Months Ended June 30,	
($ in millions)	2018	2017	2018	2017	2018	2017	2018	2017	2018	2017	2018	2017
Financial Statement Line Items in which Effects of Fair Value or Cash Flow Hedges are Recorded	$10,465	$9,930	$(48)	(73)	$(62)	$(14)	20,502	$19,365	$(340)	$(143)	$62	$132
(Gain) loss on fair value hedging relationships												
Interest rate swap contracts												
Hedged items	—	—	(15)	20	—	—	—	—	(77)	4	—	—
Derivatives designated as hedging instruments	—	—	22	(31)	—	—	—	—	84	(27)	—	—
Impact of cash flow hedging relationships												
Foreign exchange contracts												
Amount of gain (loss) recognized in OCI on derivatives	—	—	—	—	264	(169)	—	—	—	—	84	(432)
(Decrease) increase in Sales as a result of AOCI reclassifications	(73)	49	—	—	73	(49)	(166)	144	—	—	166	(144)

[1] Interest expense is a component of Other (income) expense, net.

The table below provides information regarding the income statement effects of derivatives not designated as hedging instruments:

		Amount of Derivative Pretax (Gain) Loss Recognized in Income			
		Three Months Ended June 30,		Six Months Ended June 30,	
($ in millions)	Income Statement Caption	2018	2017	2018	2017
Derivatives Not Designated as Hedging Instruments					
Foreign exchange contracts [1]	Other (income) expense, net	$(195)	$(3)	$(167)	$(49)
Foreign exchange contracts [2]	Sales	(14)	—	(5)	—

[1] 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.

[2] These derivative contracts serve as economic hedges of forecasted transactions.

At June 30, 2018, the Company estimates $29 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.

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

Investments in Debt and Equity Securities

Information on investments in debt and equity securities is as follows:

	June 30, 2018				December 31, 2017			
($ in millions)	Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses
Corporate notes and bonds	$8,782	$ 8,902	$ 2	$ (122)	$9,806	$ 9,837	$ 9	$ (40)
U.S. government and agency securities	1,620	1,640	—	(20)	2,042	2,059	—	(17)
Asset-backed securities	1,441	1,456	1	(16)	1,542	1,548	1	(7)
Foreign government bonds	649	658	—	(9)	733	739	—	(6)
Mortgage-backed securities	65	66	—	(1)	626	634	1	(9)
Commercial paper	30	30	—	—	159	159	—	—
Total debt securities	$12,587	$ 12,752	$ 3	$ (168)	$14,908	$ 14,976	$ 11	$ (79)
Publicly traded equity securities [1]	375				275	265	16	(6)
Total debt and publicly traded equity securities	$12,962				$15,183	$ 15,241	$ 27	$ (85)

[1] Pursuant to the adoption of ASU 2016-01 (see Note 1), beginning on January 1, 2018, changes in the fair value of publicly traded equity securities are recognized in net income. Unrealized net gains of $7 million and $50 million, respectively, were recognized in Other (income) expense, net during the second quarter and first six months of 2018 on equity securities still held at June 30, 2018.

At June 30, 2018, the Company also had $675 million of equity investments without readily determinable fair values included in Other Assets. During the first six months of 2018, the Company recognized unrealized gains of $129 million on certain of these equity investments recorded in Other (income) expense, net based on favorable observable price changes from transactions involving similar investments of the same investee. In addition, during the first six months of 2018, the Company recognized unrealized losses of $26 million in Other (income) expense, net related to certain of these investments based on unfavorable observable price changes.

Available-for-sale debt securities included in Short-term investments totaled $2.3 billion at June 30, 2018. Of the remaining debt securities, $9.6 billion mature within five years. At June 30, 2018 and December 31, 2017, 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 or liabilities are those whose values are determined using pricing models, discounted cash flow methodologies, or similar techniques with significant unobservable inputs, as well as assets or liabilities 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 Condensed 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)	June 30, 2018				December 31, 2017			
Assets								
Investments								
Corporate notes and bonds	$—	$ 8,684	$ —	$8,684	$—	$ 9,678	$ —	$9,678
U.S. government and agency securities	—	1,396	—	1,396	68	1,767	—	1,835
Asset-backed securities [1]	—	1,394	—	1,394	—	1,476	—	1,476
Foreign government bonds	—	649	—	649	—	732	—	732
Commercial paper	—	30	—	30	—	159	—	159
Mortgage-backed securities	—	—	—	—	—	547	—	547
Publicly traded equity securities	164	—	—	164	104	—	—	104
	164	12,153	—	12,317	172	14,359	—	14,531
Other assets [2]								
U.S. government and agency securities	64	160	—	224	—	207	—	207
Corporate notes and bonds	—	98	—	98	—	128	—	128
Mortgage-backed securities	—	65	—	65	—	79	—	79
Asset-backed securities [1]	—	47	—	47	—	66	—	66
Foreign government bonds	—	—	—	—	—	1	—	1
Publicly traded equity securities	211	—	—	211	171	—	—	171
	275	370	—	645	171	481	—	652
Derivative assets [3]								
Purchased currency options	—	142	—	142	—	80	—	80
Forward exchange contracts	—	302	—	302	—	48	—	48
Interest rate swaps	—	—	—	—	—	2	—	2
	—	444	—	444	—	130	—	130
Total assets	$439	$ 12,967	$ —	$13,406	$343	$ 14,970	$ —	$15,313
Liabilities								
Other liabilities								
Contingent consideration	$—	$ —	$ 830	$830	$—	$ —	$ 935	$935
Derivative liabilities [3]								
Forward exchange contracts	—	62	—	62	—	162	—	162
Interest rate swaps	—	132	—	132	—	55	—	55
Written currency options	—	3	—	3	—	—	—	—
	—	197	—	197	—	217	—	217
Total liabilities	$—	$ 197	$ 830	$1,027	$—	$ 217	$ 935	$1,152

[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 auto loan, credit card and student loan receivables, with

weighted-average lives of primarily 5 years or less.

(2) Investments included in other assets are restricted as to use, primarily for the payment of benefits under employee benefit plans.

(3) 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 six months of 2018. As of June 30, 2018, Cash and cash equivalents of $5.3 billion included $4.5 billion of cash equivalents (which would be considered Level 2 in the fair value hierarchy).

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

Contingent Consideration

Summarized information about the changes in liabilities for contingent consideration is as follows:

	Six Months Ended June 30,	
($ in millions)	2018	2017
Fair value January 1	$935	$891
Changes in fair value [1]	122	108
Additions	8	3
Payments	(235)	—
Fair value June 30 [2]	$830	$1,002

[1] Recorded in Research and development expenses, Materials and production costs and Other (income) expense, net. Includes cumulative translation adjustments.

[2] Balance at June 30, 2018 includes $92 million recorded as a current liability for amounts expected to be paid within the next 12 months.

The payments of contingent consideration in the first six months of 2018 include $175 million related to the achievement of a clinical milestone in connection with the 2016 acquisition of Afferent Pharmaceuticals. The remaining payments relate to liabilities recorded in connection with the 2016 termination of the Sanofi-Pasteur MSD joint venture.

Other Fair Value Measurements

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

The estimated fair value of loans payable and long-term debt (including current portion) at June 30, 2018, was $23.9 billion compared with a carrying value of $23.3 billion and at December 31, 2017, was $25.6 billion compared with a carrying value of $24.4 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.

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 global economic conditions, including the volatility associated with international sovereign economies, and associated impacts on the financial markets and its business. At June 30, 2018, the Company's total net accounts receivable outstanding for more than one year were approximately $40 million. 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.

Derivative financial instruments are executed under International Swaps and Derivatives Association master agreements. The master agreements with several of the Company's financial institution counterparties also include credit support annexes. These annexes contain provisions that require collateral to be exchanged depending on the value of the derivative assets and liabilities, the Company's credit rating, and the credit rating of the counterparty. As of June 30, 2018 and December 31, 2017, the Company had received cash collateral of $90 million and $3 million, respectively, from various counterparties and the obligation to return such collateral is recorded in Accrued and other current liabilities. The Company had not advanced any cash collateral to counterparties as of June 30, 2018 or December 31, 2017.

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

7. Inventories

Inventories consisted of:

($ in millions)	June 30, 2018	December 31, 2017
Finished goods	$1,519	$ 1,334
Raw materials and work in process	4,818	4,703
Supplies	191	201
Total (approximates current cost)	6,528	6,238
Increase to LIFO costs	11	45
	$6,539	$ 6,283
Recognized as:		
Inventories	$5,178	$ 5,096
Other assets	1,361	1,187

Amounts recognized as Other assets are comprised almost entirely of raw materials and work in process inventories. At June 30, 2018 and December 31, 2017, these amounts included $1.3 billion and $1.1 billion, respectively, of inventories not expected to be sold within one year. In addition, these amounts included $25 million and $80 million at June 30, 2018 and December 31, 2017, respectively, of inventories produced in preparation for product launches.

8. Contingencies

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 certain additional matters including governmental and environmental matters. 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 nature of the litigation discussed below 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 most product liabilities effective August 1, 2004.

Product Liability Litigation

Fosamax

As previously disclosed, Merck is a defendant in product liability lawsuits in the United States involving Fosamax (Fosamax Litigation). As of June 30, 2018, approximately 3,975 cases are filed and pending against Merck in either federal or state court. In approximately 10 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 3,965 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 (JPML) ordered that certain Fosamax product liability cases pending in federal courts nationwide should be transferred and consolidated into one multidistrict litigation (Fosamax ONJ MDL) for coordinated pre-trial proceedings.

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

In 2014, Merck settled approximately 95% of the ONJ cases pending in the Fosamax ONJ MDL and in state courts for a payment of $27.3 million. The escrow agent under the agreement has been making settlement payments to qualifying plaintiffs. The ONJ Master Settlement Agreement has no effect on the cases alleging Femur Fractures discussed below. The Fosamax ONJ MDL was closed in June 2018.

Discovery is currently ongoing in some of the approximately 10 remaining ONJ cases that are pending in various federal and state courts and 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. All federal cases involving allegations of Femur Fracture have been or will be transferred to a multidistrict litigation in the District of New Jersey (Femur Fracture MDL). In the only bellwether case tried to date in the Femur Fracture MDL, Glynn v. Merck, the jury returned a verdict in Merck's favor. In addition, in June 2013, the Femur Fracture MDL court granted Merck's motion for judgment as a matter of law in the Glynn case and held that the plaintiff's failure to warn claim was preempted by federal law.

In August 2013, the Femur Fracture MDL court entered an order requiring plaintiffs in the Femur Fracture MDL to show cause why those cases asserting claims for a femur fracture injury that took place prior to September 14, 2010, should not be dismissed based on the court's preemption decision in the Glynn case. Pursuant to the show cause order, in March 2014, the Femur Fracture MDL court dismissed with prejudice approximately 650 cases on preemption grounds. Plaintiffs in approximately 515 of those cases appealed that decision to the U.S. Court of Appeals for the Third Circuit (Third Circuit). In March 2017, the Third Circuit issued a decision reversing the Femur Fracture MDL court's preemption ruling and remanding the appealed cases back to the Femur Fracture MDL court. Merck filed a petition for a writ of certiorari to the U.S. Supreme Court in August 2017 seeking review of the Third Circuit's decision. In December 2017, the Supreme Court invited the Solicitor General to file a brief in the case expressing the views of the United States, and in May 2018, the Solicitor General submitted a brief stating that the Third Circuit's decision was wrongly decided and recommended that the Supreme Court grant Merck's cert petition. The Supreme Court granted Merck's petition in June 2018, and final decision on the Femur Fracture MDL court's preemption ruling is now pending before the Supreme Court.

In addition, in June 2014, the Femur Fracture MDL court granted Merck summary judgment in the Gaynor v. Merck case and found that Merck's updates in January 2011 to the Fosamax label regarding atypical femur fractures were adequate as a matter of law and that Merck adequately communicated those changes. The plaintiffs in Gaynor did not appeal the Femur Fracture MDL court's findings with respect to the adequacy of the 2011 label change, but did appeal the dismissal of their case based on preemption grounds and a final decision on that issue is now pending before the Supreme Court. In August 2014, Merck filed a motion requesting that the Femur Fracture MDL court enter a further order requiring all plaintiffs in the Femur Fracture MDL who claim that the 2011 Fosamax label is inadequate and the proximate cause of their alleged injuries to show cause why their cases should not be dismissed based on the court's preemption decision and its ruling in the Gaynor case. In November 2014, the court granted Merck's motion and entered the requested show cause order. No plaintiffs responded to or appealed the November 2014 show cause order.

As of June 30, 2018, approximately 300 cases were pending in the Femur Fracture MDL following the reinstatement of the cases that had been on appeal to the Third Circuit. In addition, approximately 755 cases have been dismissed without prejudice pending final resolution by the Supreme Court of the appeal of the Femur Fracture MDL court's preemption order.

As of June 30, 2018, approximately 2,630 cases alleging Femur Fractures have been filed in New Jersey state court and are pending before Judge James Hyland in Middlesex County. The parties selected an initial group of 30 cases to be reviewed through fact discovery. Two additional groups of 50 cases each to be reviewed through fact discovery were selected in November 2013 and March 2014, respectively. A further group of 25 cases to be reviewed through fact discovery was selected by Merck in July 2015, and Merck has continued to select additional cases to be reviewed through fact discovery from 2016 to the present.

As of June 30, 2018, approximately 275 cases alleging Femur Fractures have been filed and are pending in California state court. All of the Femur Fracture cases filed in California state court have been coordinated before a single judge

in Orange County, California. In March 2014, the court directed that a group of 10 discovery pool cases be reviewed through fact discovery and subsequently scheduled the Galper v. Merck case, which plaintiffs selected, as the first trial. The Galper trial began in February 2015 and the jury returned a verdict in Merck's favor in April 2015, and plaintiff appealed that verdict to the California appellate court. In April 2017, the California appellate court issued a decision affirming the lower court's judgment in favor of Merck. The next Femur Fracture trial in California that was scheduled to begin in April 2016 was stayed at plaintiffs' request and a new trial date has not been set.
Additionally, there are four Femur Fracture cases pending in other state courts.
Discovery is ongoing in the Femur Fracture MDL and in state courts where Femur Fracture cases are pending and the Company intends to defend against these lawsuits.

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

Januvia/Janumet

As previously disclosed, Merck is a defendant in product liability lawsuits in the United States involving Januvia and/or Janumet. As of June 30, 2018, Merck is aware of approximately 1,260 product user claims alleging generally that use of Januvia and/or Janumet caused the development of pancreatic cancer and other injuries. These complaints were filed in several different state and federal courts.

Most of the claims were filed in a consolidated multidistrict litigation proceeding in the U.S. District Court for the Southern District of California called "In re Incretin-Based Therapies Products Liability Litigation" (MDL). The MDL includes federal lawsuits alleging pancreatic cancer due to use of the following medicines: Januvia, Janumet, Byetta and Victoza, the latter two of which are products manufactured by other pharmaceutical companies. The majority of claims not filed in the MDL were filed in the Superior Court of California, County of Los Angeles (California State Court).

In November 2015, the MDL and California State Court - in separate opinions - granted summary judgment to defendants on grounds of preemption. Of the approximately 1,260 product user claims, these rulings resulted in the dismissal of approximately 1,100 product user claims.

Plaintiffs appealed the MDL and California State Court preemption rulings. In November 2017, the U.S. Court of Appeals for the Ninth Circuit (Ninth Circuit) reversed the trial court's ruling in the MDL and remanded for further proceedings. The Ninth Circuit did not address the substance of defendants' preemption argument but instead ruled that the district court made various errors during discovery. Jurisdiction returned to U.S. District Court for the Southern District of California on January 2, 2018. The preemption appeal in the California state court litigation has been fully briefed, but the court has not yet scheduled oral argument.

On March 21, 2018, the district court in the MDL entered a case management order setting forth a schedule for completing discovery on general causation and preemption issues and for renewing summary judgment and Daubert motions. The filing deadline for Daubert and summary judgment motions is set for December 11, 2018.

As of June 30, 2018, seven product users have claims pending against Merck in state courts other than California state court, including four active product user claims pending in Illinois state court. In June 2017, the Illinois trial court denied Merck's motion for summary judgment on grounds of preemption. Merck sought permission to appeal that order on an interlocutory basis and was granted a stay of proceedings in the trial court. In September 2017, an intermediate appellate court in Illinois denied Merck's petition for interlocutory review. Merck filed a petition for review with the Illinois Supreme Court and, on January 18, 2018, the Illinois Supreme Court directed the appellate court to answer the certified question. Briefing in the intermediate appellate court has concluded. Proceedings in the trial court remain stayed.

In addition to the claims noted above, the Company has agreed to toll the statute of limitations for approximately 50 additional claims. The Company intends to continue defending against these lawsuits.

Propecia/Proscar

As previously disclosed, Merck is a defendant in product liability lawsuits in the United States involving Propecia and/or Proscar. As of June 30, 2018, there were approximately 600 active lawsuits filed by plaintiffs who allege that they have experienced persistent sexual side effects following cessation of treatment with Propecia and/or Proscar. Approximately 15 of the plaintiffs also allege that Propecia or Proscar has caused or can cause prostate cancer, testicular cancer or male breast cancer. The lawsuits have been filed in various federal courts and in state court in New Jersey. The federal lawsuits have been consolidated for pretrial purposes in a federal multidistrict litigation before Judge Brian Cogan of the Eastern District of New York. The matters pending in state court in New Jersey have been consolidated before Judge Hyland in Middlesex County (NJ Coordinated Proceedings). In addition, there is one matter pending in state court in California, one matter pending in state court in Ohio, and one matter pending in state court in Massachusetts.

As previously disclosed, on April 9, 2018, Merck and the Plaintiffs' Executive Committee in the MDL and the Plaintiffs' Liaison Counsel in the NJ Coordinated Proceedings entered into an agreement to resolve the above mentioned Propecia/Proscar lawsuits for an aggregate amount of $4.3 million. The settlement is subject to certain contingencies, including 95% plaintiff participation and a per plaintiff clawback if the participation rate is less than 100%.

The Company intends to defend against any remaining unsettled lawsuits.

Governmental Proceedings

As previously disclosed, the Company's subsidiaries in China have received and may continue to receive inquiries regarding their operations from various Chinese governmental agencies. Some of these inquiries may be related to matters involving other multinational pharmaceutical companies, as well as Chinese entities doing business with such companies. The Company's policy is to cooperate with these authorities and to provide responses as appropriate.

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

As previously disclosed, from time to time, the Company receives inquiries and is the subject of preliminary investigation activities from competition and other governmental authorities in markets outside the United States. These authorities may include regulators, administrative authorities, and law enforcement and other similar officials, and these preliminary investigation activities may include site visits, formal or informal requests or demands for documents or materials, inquiries or interviews and similar matters. Certain of these preliminary inquiries or activities may lead to the commencement of formal proceedings. Should those proceedings be determined adversely to the Company, monetary fines and/or remedial undertakings may be required.

Commercial and Other Litigation

Merck KGaA Litigation

In January 2016, to protect its long-established brand rights in the United States, the Company filed a lawsuit against Merck KGaA, Darmstadt, Germany (KGaA), historically operating as the EMD Group in the United States, alleging it improperly uses the name “Merck” in the United States. KGaA has filed suit against the Company in France, the UK, Germany, Switzerland, Mexico, India, Australia, Singapore, Hong Kong, and China alleging, among other things, unfair competition, trademark infringement and corporate name infringement. In the UK, Australia, Singapore, and Hong Kong, KGaA also alleges breach of the parties’ coexistence agreement. In December 2015, the Paris Court of First Instance issued a judgment finding that certain activities by the Company directed towards France did not constitute trademark infringement and unfair competition while other activities were found to infringe. The Company and KGaA appealed the decision, and the appeal was heard in May 2017. In June 2017, the French appeals court held that certain of the activities by the Company directed to France constituted unfair competition or trademark infringement and no further appeal was pursued. In January 2016, the UK High Court issued a judgment finding that the Company had breached the co-existence agreement and infringed KGaA’s trademark rights as a result of certain activities directed towards the UK based on use of the word MERCK on promotional and information activity. As noted in the UK decision, this finding was not based on the Company’s use of the sign MERCK in connection with the sale of products or any material pharmaceutical business transacted in the UK. The Company and KGaA have both appealed this decision, and the appeal was heard in June 2017. In November 2017, the UK Court of Appeals affirmed the decision on the co-existence agreement and remitted for re-hearing issues of trademark infringement, the scope of KGaA’s UK trademarks for pharmaceutical products, and the relief to which KGaA would be entitled. The re-hearing was held, and no decision has been handed down.

In re Rotavirus Vaccines Antitrust Litigation

On April 25 and May 2, 2018, Sugartown Pediatrics, LLC and Schwartz Pediatrics, respectively, filed putative class actions against Merck in the Eastern District of Pennsylvania on behalf of all direct purchasers of RotaTeq from April 25, 2014 through present, alleging that Merck violated Sections 1 and 2 of the Sherman Act. On June 15, 2018, plaintiffs filed a consolidated amended complaint, substituting MSD as the defendant, and on July 23, Margiotti & Kroll Pediatrics, P.C. filed a substantially similar complaint in the consolidated proceeding. Plaintiffs allege that MSD has implemented an anticompetitive vaccine bundling scheme whereby MSD leverages its monopoly power in multiple pediatric vaccine markets to maintain its monopoly power in the U.S. market for rotavirus vaccines. Plaintiffs seek to recover unspecified overcharge damages on their purchases of RotaTeq, trebled, and fees and costs.

Patent Litigation

From time to time, generic manufacturers of pharmaceutical products file abbreviated New Drug Applications with the U.S. Food and Drug Administration (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. 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 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 acquisitions, potentially significant intangible asset impairment charges.

Inegy — The patents protecting Inegy in Europe have expired but supplemental protection certificates (SPCs) have been granted to the Company in many European countries that will expire in April 2019. There are multiple challenges to

the SPCs related to Inegy throughout Europe and generic products have been launched in France, Italy, Ireland, Spain, Portugal, Norway and Netherlands. The Company has filed for preliminary injunctions in many countries that are still pending decision. Preliminary injunctions have been granted in Germany and Portugal. Preliminary injunctions have been denied in France, Belgium, Ireland, Netherlands and the Czech Republic. The Company is appealing those decisions. The Company will file actions for patent infringement seeking damages against those companies that launch generic products before April 2019.

Noxafil — In August 2015, the Company filed a lawsuit against Actavis Laboratories Fl, Inc. (Actavis) in the United States in respect of that company's application to the FDA seeking pre-patent expiry approval to sell a generic version of Noxafil. In October 2017, the district court held the patent valid and infringed. Actavis appealed this decision. While the appeal was pending, the parties reached a settlement, subject to certain terms of the agreement being met, whereby Actavis can launch its generic version

prior to expiry of the patent and pediatric exclusivity under certain conditions. In March 2016, the Company filed a lawsuit against Roxane Laboratories, Inc. (Roxane) in the United States in respect of that company's application to the FDA seeking pre-patent expiry approval to sell a generic version of Noxafil. In November 2017, the parties reached a settlement whereby Roxane can launch its generic version prior to expiry of the patent under certain conditions. In February 2016, the Company filed a lawsuit against Par Sterile Products LLC, Par Pharmaceutical, Inc., Par Pharmaceutical Companies, Inc. and Par Pharmaceutical Holdings, Inc. (collectively, Par) in the United States in respect of that company's application to the FDA seeking pre-patent expiry approval to sell a generic version of Noxafil injection. In October 2016, the parties reached a settlement whereby Par can launch its generic version in January 2023, or earlier under certain conditions. In February 2018, the Company filed a lawsuit against Fresenius Kabi USA, LLC., in the United States in respect of that company's application to the FDA seeking pre-patent expiry approval to sell a generic version of Noxafil. In March 2018, the Company filed a lawsuit against Mylan Laboratories Limited in the United States in respect of that company's application to the FDA seeking pre-patent expiry approval to sell a generic version of Noxafil.

Nasonex — Nasonex lost market exclusivity in the United States in 2016. Prior to that, in April 2015, the Company filed a patent infringement lawsuit against Apotex Inc. and Apotex Corp. (Apotex) in respect of Apotex's marketed product that the Company believed was infringing. In January 2018, the Company and Apotex settled this matter with Apotex agreeing to pay the Company $115 million plus certain other consideration.

Gilead Patent Litigation and Opposition

In August 2013, Gilead Sciences, Inc. (Gilead) filed a lawsuit in the U.S. District Court for the Northern District of California seeking a declaration that two Company patents were invalid and not infringed by the sale of their two sofosbuvir containing products, Sovaldi and Harvoni. The Company filed a counterclaim that the sale of these products did infringe these two patents and sought a reasonable royalty for the past, present and future sales of these products. In March 2016, at the conclusion of a jury trial, the patents were found to be not invalid and infringed. The jury awarded the Company $200 million as a royalty for sales of these products up to December 2015. After the conclusion of the jury trial, the court held a bench trial on the equitable defenses raised by Gilead. In June 2016, the court found for Gilead and determined that Merck could not collect the jury award and that the patents were unenforceable with respect to Gilead. The Company appealed the court's decision. Gilead also asked the court to overturn the jury's decision on validity. The court held a hearing on Gilead's motion in August 2016, and the court subsequently rejected Gilead's request, which Gilead appealed. In April 2018, the appeals court affirmed the decisions that both patents were unenforceable against Gilead.

The Company, through its Idenix Pharmaceuticals, Inc. subsidiary, has pending litigation against Gilead in the United States, Germany and France based on different patent estates that would also be infringed by Gilead's sales of these two products. Gilead opposed the European patent at the European Patent Office (EPO). Trial in the United States was held in December 2016 and the jury returned a verdict for the Company, awarding damages of $2.54 billion. The Company submitted post-trial motions, including on the issues of enhanced damages and future royalties. Gilead submitted post-trial motions for judgment as a matter of law. A hearing on the motions was held in September 2017. Also, in September 2017, the court denied the Company's motion on enhanced damages, granted its motion on prejudgment interest and deferred its motion on future royalties. In February 2018, the court granted Gilead's motion for judgment as a matter of law and found the patent was invalid for a lack of enablement. The Company appealed this decision. The EPO opposition division revoked the European patent, and the Company appealed this decision. The cases in France and Germany have been stayed pending the final decision of the EPO.

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 June 30, 2018 and December 31, 2017 of approximately $155 million and $160 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

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

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.

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 at January 1, 2017	3,577	$ 1,788	$39,939	$44,133	$ (5,226)	828	$(40,546)	$ 220	$40,308
Net income attributable to Merck & Co., Inc.	—	—	—	3,496	—	—	—	—	3,496
Other comprehensive income, net of taxes	—	—	—	—	132	—	—	—	132
Cash dividends declared on common stock	—	—	—	(2,583)	—	—	—	—	(2,583)
Treasury stock shares purchased	—	—	—	—	—	34	(2,153)	—	(2,153)
Share-based compensation plans and other	—	—	(163)	—	—	(12)	646	—	483
Acquisition of Vallée	—	—	—	—	—	—	—	25	25
Net income attributable to noncontrolling interests	—	—	—	—	—	—	—	11	11
Other changes in noncontrolling ownership interests	—	—	—	—	—	—	—	(7)	(7)
Balance at June 30, 2017	3,577	$ 1,788	$39,776	$45,046	$ (5,094)	850	$(42,053)	$ 249	$39,712
Balance at January 1, 2018	3,577	$ 1,788	$39,902	$41,350	$ (4,910)	880	$(43,794)	$ 233	$34,569
Adoption of new accounting standards (see Note 1)	—	—	—	322	(274)	—	—	—	48
Net income attributable to Merck & Co., Inc.	—	—	—	2,443	—	—	—	—	2,443
Other comprehensive income, net of taxes	—	—	—	—	62	—	—	—	62
Cash dividends declared on common stock	—	—	—	(2,592)	—	—	—	—	(2,592)
Treasury stock shares purchased	—	—	—	—	—	37	(2,162)	—	(2,162)
Share-based compensation plans and other	—	—	(161)	—	—	(10)	555	—	394
Net income attributable to noncontrolling interests	—	—	—	—	—	—	—	14	14
Distributions attributable to noncontrolling interests	—	—	—	—	—	—	—	(10)	(10)
Balance at June 30, 2018	3,577	$ 1,788	$39,741	$41,523	$ (5,122)	907	$(45,401)	$ 237	$32,766

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 and non-employee directors 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 the amounts of share-based compensation cost recorded in the Condensed Consolidated Statement of Income:

	Three Months	Six Months Ended

	Ended June 30,		June 30,	
($ in millions)	2018	2017	2018	2017
Pretax share-based compensation expense	$90	$82	$170	$156
Income tax benefit	(13)	(25)	(28)	(47)
Total share-based compensation expense, net of taxes	$77	$57	$142	$109

During the first six months of 2018 and 2017, the Company granted 7 million RSUs with a weighted-average grant date fair value of $58.15 per RSU and 5 million RSUs with a weighted-average grant date fair value of $63.97 per RSU, respectively. During the first six months of 2018 and 2017, the Company granted 855 thousand PSUs with a weighted-average grant date fair value of $56.70 per PSU and 1 million PSUs with a weighted-average grant date fair value of $63.62 per PSU, respectively.

During the first six months of 2018 and 2017, the Company granted 3 million stock options with a weighted-average exercise price of $57.72 per option and 4 million stock options with a weighted-average exercise price of $63.98 per option, respectively. The weighted-average fair value of options granted for the first six months of 2018 and 2017 was $8.19 and $7.05 per option, respectively, and was determined using the following assumptions:

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

	Six Months Ended June 30,	
	2018	2017
Expected dividend yield	3.4 %	3.6 %
Risk-free interest rate	2.8 %	2.0 %
Expected volatility	19.1%	17.9%
Expected life (years)	6.1	6.1

At June 30, 2018, there was $758 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. 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 periodic benefit cost (credit) of such plans consisted of the following components:

	Three Months Ended June 30,				Six Months Ended June 30,			
	2018		2017		2018		2017	
($ in millions)	U.S.	International	U.S.	International	U.S.	International	U.S.	International
Service cost	$85	$ 58	$77	$ 63	$168	$ 125	$154	$ 124
Interest cost	107	45	113	42	215	91	226	83
Expected return on plan assets	(211)	(108)	(218)	(97)	(425)	(221)	(436)	(191)
Amortization of unrecognized prior service credit	(13)	(3)	(13)	(3)	(25)	(7)	(27)	(5)
Net loss amortization	56	21	44	24	112	43	89	47
Termination benefits	7	—	3	1	17	—	8	2
Curtailments	5	(1)	1	(1)	3	(1)	4	(1)
Settlements	—	4	—	—	1	4	—	—
	$36	$ 16	$7	$ 29	$66	$ 34	$18	$ 59

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 (credit) of such plans consisted of the following components:

	Three Months Ended June 30,		Six Months Ended June 30,	
($ in millions)	2018	2017	2018	2017
Service cost	$14	$14	$28	$28
Interest cost	18	20	35	40
Expected return on plan assets	(21)	(20)	(41)	(39)
Amortization of unrecognized prior service credit	(21)	(24)	(42)	(49)
Termination benefits	1	—	2	1
Curtailments	(2)	(2)	(6)	(5)
	$(11)	$(12)	$(24)	$(24)

In connection with restructuring actions (see Note 5), 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 pension and other postretirement benefit plans as reflected in the tables above.

The components of net periodic benefit cost (credit) other than the service cost component are included in Other (income) expense, net (see Note 12), with the exception of certain amounts for termination benefits, curtailments and

settlements, which are recorded in Restructuring costs if the event giving rise to the termination benefits, curtailment or settlement is related to restructuring actions as noted above.

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

12. Other (Income) Expense, Net

Other (income) expense, net, consisted of:

	Three Months Ended June 30,		Six Months Ended June 30,	
($ in millions)	2018	2017	2018	2017
Interest income	$(81)	$(96)	$(165)	$(194)
Interest expense	194	193	379	375
Exchange losses	71	19	77	11
Equity (gains) losses from affiliates	(64)	(5)	(12)	8
Net periodic defined benefit plan (credit) cost other than service cost	(130)	(131)	(265)	(260)
Other, net	(38)	(53)	(354)	(83)
	$(48)	$(73)	$(340)	$(143)

Other, net (as reflected in the table above) in the first six months of 2018 includes a $115 million gain on the settlement of certain patent litigation (see Note 8).

Interest paid for the six months ended June 30, 2018 and 2017 was $341 million and $343 million, respectively.

13. Taxes on Income

The effective income tax rates of 17.8% and 20.0% for the second quarter of 2018 and 2017, respectively, and 28.4% and 21.0% for the first six months of 2018 and 2017, respectively, reflect the impacts of acquisition and divestiture-related costs and restructuring costs, partially offset by the beneficial impact of foreign earnings. In addition, the effective income tax rate for the first six months of 2018 reflects the unfavorable impact of a $1.4 billion aggregate pretax charge recorded in connection with the formation of an oncology collaboration with Eisai for which no tax benefit was recognized. The effective income tax rates for the second quarter and first six months of 2017 also reflect a benefit of $88 million related to the settlement of a state income tax issue.

On December 22, 2017, new U.S. tax legislation known as the Tax Cuts and Jobs Act of 2017 (TCJA) was enacted. Among other provisions, the TCJA reduced the U.S. federal corporate statutory tax rate from 35% to 21% effective January 1, 2018, requires companies to pay a one-time transition tax on undistributed earnings of certain foreign subsidiaries, and creates new taxes on certain foreign sourced earnings. The Company reflected the impact of the TCJA in its 2017 financial statements as described below. However, application of certain provisions of the TCJA was and remains subject to further interpretation and in these instances the Company made a reasonable estimate of the effects of the TCJA. No changes to these amounts were recognized in the first six months of 2018 and they remain provisional.

The one-time transition tax is based on the Company’s post-1986 undistributed earnings and profits (E&P). For a substantial portion of these undistributed E&P, the Company had not previously provided deferred taxes as these earnings were deemed by Merck to be retained indefinitely by subsidiary companies for reinvestment. The Company recorded a provisional amount for its one-time transition tax liability of $5.3 billion. Merck has not yet finalized its calculation of the total post-1986 undistributed E&P for these foreign subsidiaries. The transition tax is based in part on the amount of undistributed E&P held in cash and other specified assets; therefore, this amount may change when the Company finalizes its calculation of post-1986 undistributed foreign E&P and finalizes the amounts held in cash or other specified assets. This provisional amount was reduced by the reversal of $2.0 billion of deferred taxes that were previously recorded in connection with the merger of Schering-Plough Corporation in 2009 for certain undistributed foreign E&P. The Company anticipates that it will be able to utilize certain foreign tax credits to partially reduce the transition tax payment, resulting in a net transition tax payment of $5.1 billion.

The Company remeasured its deferred tax assets and liabilities at the new federal statutory tax rate of 21%, which resulted in a provisional deferred tax benefit of $779 million. The deferred tax benefit calculation remains subject to certain clarifications, particularly related to executive compensation and benefits.

Beginning in 2018, the TCJA includes a tax on “global intangible low-taxed income” (GILTI) as defined in the TCJA. The Company is allowed to make an accounting policy election to account for the tax effects of the GILTI tax either

in the income tax provision in future periods as the tax arises, or as a component of deferred taxes on the related investments in foreign subsidiaries. The Company is currently evaluating the GILTI provisions of the TCJA and the implications on its tax provision and has not finalized the accounting policy election; therefore, the Company has not recorded deferred taxes for GILTI.

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

14. Earnings Per Share

The calculations of earnings per share are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
($ and shares in millions except per share amounts)	2018	2017	2018	2017
Net income attributable to Merck & Co., Inc.	$1,707	$1,946	$2,443	$3,496
Average common shares outstanding	2,683	2,734	2,689	2,739
Common shares issuable [1]	13	18	13	20
Average common shares outstanding assuming dilution	2,696	2,752	2,702	2,759
Basic earnings per common share attributable to Merck & Co., Inc. common shareholders	$0.64	$0.71	$0.91	$1.28
Earnings per common share assuming dilution attributable to Merck & Co., Inc. common shareholders	$0.63	$0.71	$0.90	$1.27

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

For the three months ended June 30, 2018 and 2017, 13 million and 5 million, respectively, and for the first six months of 2018 and 2017, 15 million and 4 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.

15. Other Comprehensive Income (Loss)

Changes in AOCI by component are as follows:

	Three Months Ended June 30,				
($ in millions)	Derivatives	Investments	Employee Benefit Plans	Cumulative Translation Adjustment	Accumulated Other Comprehensive Income (Loss)
Balance April 1, 2017, net of taxes	$106	$ 40	$(3,180)	$ (2,046)	$ (5,080)
Other comprehensive income (loss) before reclassification adjustments, pretax	(169)	26	29	(25)	(139)
Tax	59	3	(3)	72	131
Other comprehensive income (loss) before reclassification adjustments, net of taxes	(110)	29	26	47	(8)
Reclassification adjustments, pretax	(50) [1]	8 [2]	27 [3]	—	(15)
Tax	17	(2)	(6)	—	9
Reclassification adjustments, net of taxes	(33)	6	21	—	(6)
Other comprehensive income (loss), net of taxes	(143)	35	47	47	(14)
Balance June 30, 2017, net of taxes	$(37)	$ 75	$(3,133)	$ (1,999)	$ (5,094)
Balance April 1, 2018, net of taxes	$(201)	$ (167)	$(3,095)	$ (1,597)	$ (5,060)
Other comprehensive income (loss) before reclassification adjustments, pretax	265	(17)	(1)	(301)	(54)
Tax	(56)	—	1	(60)	(115)
Other comprehensive income (loss) before reclassification adjustments, net of taxes	209	(17)	—	(361)	(169)
Reclassification adjustments, pretax	72 [1]	20 [2]	40 [3]	—	132
Tax	(15)	—	(10)	—	(25)
Reclassification adjustments, net of taxes	57	20	30	—	107
Other comprehensive income (loss), net of taxes	266	3	30	(361)	(62)

Balance June 30, 2018, net of taxes	$65	$ (164)	$ (3,065)	$ (1,958)	$ (5,122)

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

	Six Months Ended June 30,				
($ in millions)	Derivatives	Investments	Employee Benefit Plans	Cumulative Translation Adjustment	Accumulated Other Comprehensive Income (Loss)
Balance January 1, 2017, net of taxes	$338	$ (3)	$ (3,206)	$ (2,355)	$ (5,226)
Other comprehensive income (loss) before reclassification adjustments, pretax	(432)	113	25	238	(56)
Tax	151	(4)	6	118	271
Other comprehensive income (loss) before reclassification adjustments, net of taxes	(281)	109	31	356	215
Reclassification adjustments, pretax	(145) [1]	(49) [2]	55 [3]	—	(139)
Tax	51	18	(13)	—	56
Reclassification adjustments, net of taxes	(94)	(31)	42	—	(83)
Other comprehensive income (loss), net of taxes	(375)	78	73	356	132
Balance June 30, 2017, net of taxes	$ (37)	$ 75	$ (3,133)	$ (1,999)	$ (5,094)
Balance January 1, 2018, net of taxes	$ (108)	$ (61)	$ (2,787)	$ (1,954)	$ (4,910)
Other comprehensive income (loss) before reclassification adjustments, pretax	84	(133)	(2)	18	(33)
Tax	(18)	1	4	(122)	(135)
Other comprehensive income (loss) before reclassification adjustments, net of taxes	66	(132)	2	(104)	(168)
Reclassification adjustments, pretax	164 [1]	36 [2]	81 [3]	—	281
Tax	(34)	—	(17)	—	(51)
Reclassification adjustments, net of taxes	130	36	64	—	230
Other comprehensive income (loss), net of taxes	196	(96)	66	(104)	62
Reclassification of provisional stranded tax effects (see Note 1)	(23)	1	(344)	100	(266)
Adoption of ASU 2016-01 (see Note 1)	—	(8)	—	—	(8)
Balance June 30, 2018, net of taxes	$65	$ (164)	$ (3,065)	$ (1,958)	$ (5,122)

(1) Relates to foreign currency cash flow hedges that were reclassified from AOCI to Sales.

(2) Represents net realized (gains) losses on the sales of available-for-sale investments that were reclassified from AOCI to Other (income) expense, net. In 2017, these amounts included both debt and equity investments; however, upon adoption of ASU 2016-01 in 2018 (see Note 1), these amounts relate only to available-for-sale debt investments.

(3) Includes net amortization of prior service cost and actuarial gains and losses included in net periodic benefit cost (see Note 11).

16. Segment Reporting

The Company’s operations are principally managed on a products basis and include four operating segments, which are the Pharmaceutical, Animal Health, Healthcare Services and Alliances segments. The Pharmaceutical and Animal Health segments are the only reportable segments. The Animal Health segment met the criteria for separate reporting and became a reportable segment in the first quarter of 2018.

The Pharmaceutical segment includes human health pharmaceutical and vaccine products. Human health pharmaceutical products consist of therapeutic and preventive agents, generally sold by prescription, for the treatment of human disorders. The Company sells these human health pharmaceutical products primarily to drug wholesalers

and retailers, hospitals, government agencies and managed health care providers such as health maintenance organizations, pharmacy benefit managers and other institutions. Vaccine products consist of preventive pediatric, adolescent and adult vaccines, primarily administered at physician offices. The Company sells these human health vaccines primarily to physicians, wholesalers, physician distributors and government entities. A large component of pediatric and adolescent vaccine sales are made to the U.S. Centers for Disease Control and Prevention Vaccines for Children program, which is funded by the U.S. government. Additionally, the Company sells vaccines to the Federal government for placement into vaccine stockpiles.

The Company’s Animal Health segment discovers, develops, manufactures and markets animal health products, including vaccines, which the Company sells to veterinarians, distributors and animal producers.

The Company’s Healthcare Services segment provides services and solutions that focus on engagement, health analytics and clinical services to improve the value of care delivered to patients.

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

Sales of the Company's products were as follows:

	Three Months Ended June 30,						Six Months Ended June 30,					
	2018			2017			2018			2017		
($ in millions)	U.S.	Int'l	Total	U.S.	Int'l	Total	U.S.	Int'l	Total	U.S.	Int'l	Total
Pharmaceutical:												
Oncology												
Keytruda	$959	$707	$1,667	$556	$325	$881	$1,797	$1,333	$3,131	$917	$547	$1,4
Emend	89	59	148	83	60	143	168	105	273	169	107	276
Temodar	1	54	56	3	61	65	2	111	113	4	126	130
Alliance revenue - Lynparza	31	13	44	—	—	—	55	22	76	—	—	—
Alliance revenue - Lenvima	—	35	35	—	—	—	—	35	35	—	—	—
Vaccines												
Gardasil/Gardasil 9	302	306	608	312	156	469	682	586	1,269	711	290	1,00
ProQuad/M-M-R II/Varivax	356	70	426	341	58	399	668	150	818	639	115	754
Pneumovax 23	122	71	193	104	61	166	234	137	372	219	110	329
RotaTeq	99	57	156	72	51	123	250	99	349	251	96	347
Zostavax	1	43	44	107	52	160	17	91	108	216	97	313
Hospital Acute Care												
Bridion	95	145	240	54	109	163	175	269	444	99	211	310
Noxafil	87	100	188	77	78	155	168	195	363	142	154	296
Invanz	87	63	149	93	57	150	177	123	300	175	111	286
Cubicin	48	46	94	53	50	103	95	97	192	107	92	198
Cancidas	4	83	87	6	106	112	7	171	178	11	222	233
Primaxin	—	68	68	1	70	71	5	135	140	2	132	133
Immunology												
Simponi	—	233	233	—	199	199	—	464	464	—	383	383
Remicade	—	157	157	—	208	208	—	324	324	—	437	437
Neuroscience												
Belsomra	29	42	71	25	28	52	52	73	125	45	49	94
Virology												
Isentress/Isentress HD	132	174	305	136	146	282	260	326	586	279	308	587
Zepatier	(10)	123	113	256	261	517	(10)	253	243	455	440	895
Cardiovascular												
Zetia	8	218	226	122	246	367	25	505	531	233	468	701
Vytorin	3	152	155	30	152	182	11	311	322	120	303	423
Atozet	—	101	101	—	63	63	—	174	174	—	112	112
Adempas	—	75	75	—	67	67	—	143	143	—	151	151
Diabetes												
Januvia	503	446	949	541	407	948	968	862	1,829	1,048	740	1,78
Janumet	209	377	585	248	315	563	401	729	1,129	442	617	1,059
Women's Health												
NuvaRing	187	49	236	153	47	199	357	95	452	265	94	359
Implanon/Nexplanon	114	60	174	125	53	178	242	106	348	257	92	349
Diversified Brands												
Singulair	5	180	185	6	197	203	11	350	360	12	377	389
Cozaar/Hyzaar	7	118	125	3	116	119	14	231	245	6	226	231

Nasonex	—	81	81	21	64	85	2	201	203	39	185	224
Arcoxia	—	84	84	—	89	89	—	166	166	—	192	192
Follistim AQ	27	43	70	32	47	79	56	81	138	74	86	160
Fosamax	3	56	59	2	65	66	1	113	114	3	124	127
Dulera	35	7	42	63	5	69	85	14	99	139	12	151
Other pharmaceutical [1]	289	765	1,053	304	761	1,064	563	1,483	2,045	611	1,449	2,062
Total Pharmaceutical segment sales	3,822	5,461	9,282	3,929	4,830	8,759	7,538	10,663	18,201	7,690	9,255	16,94
Animal Health:												
Livestock	107	526	633	103	479	582	231	1,055	1,286	223	938	1,161
Companion Animals	204	253	457	167	206	373	387	482	869	330	403	733
Total Animal Health segment sales	311	779	1,090	270	685	955	618	1,537	2,155	553	1,341	1,894
Other segment sales [2]	56	—	56	101	—	101	140	—	140	194	—	195
Total segment sales	4,189	6,240	10,428	4,300	5,515	9,815	8,296	12,200	20,496	8,437	10,596	19,03
Other [3]	54	(18)	37	8	108	115	80	(74)	6	66	266	332
	$4,243	$6,222	$10,465	$4,308	$5,623	$9,930	$8,376	$12,126	$20,502	$8,503	$10,862	$19,

(1) Other pharmaceutical primarily reflects sales of other human health pharmaceutical products, including products within the franchises not listed separately.

(2) Represents the non-reportable segments of Healthcare Services and Alliances.

(3) Other is primarily comprised of miscellaneous corporate revenues, including revenue hedging activities, as well as third-party manufacturing sales. Other in the first six months of 2018 and 2017 also includes $71 million and $50 million, respectively, related to the sale of the marketing rights to certain products.

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

Consolidated revenues by geographic area where derived are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
($ in millions)	2018	2017	2018	2017
United States	$4,243	$4,308	$8,376	$8,503
Europe, Middle East and Africa	3,144	2,804	6,334	5,433
Asia Pacific	1,350	1,056	2,588	2,054
Japan	855	839	1,592	1,544
Latin America	594	583	1,126	1,068
Other	279	340	486	763
	$10,465	$9,930	$20,502	$19,365

A reconciliation of segment profits to Income before taxes is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
($ in millions)	2018	2017	2018	2017
Segment profits:				
Pharmaceutical segment	$5,826	$5,590	$11,630	$10,751
Animal Health segment	450	395	864	812
Other segments	26	111	88	144
Total segment profits	6,302	6,096	12,582	11,707
Other profits	(2)	43	(89)	186
Unallocated:				
Interest income	81	96	165	194
Interest expense	(194)	(193)	(379)	(375)
Equity income from affiliates	66	5	16	(7)
Depreciation and amortization	(332)	(332)	(682)	(702)
Research and development	(2,041)	(1,560)	(5,023)	(3,191)
Amortization of purchase accounting adjustments	(732)	(779)	(1,464)	(1,557)
Restructuring costs	(228)	(166)	(323)	(317)
Other unallocated, net	(834)	(771)	(1,371)	(1,496)
	$2,086	$2,439	$3,432	$4,442

Pharmaceutical segment profits are comprised of segment sales less standard costs, as well as marketing and administrative expenses and research and development costs directly incurred by the segment. Animal Health segment profits are comprised of segment sales, less all materials and production costs, as well as marketing and administrative expenses and research and development costs directly incurred by the segment. For internal management reporting presented to the chief operating decision maker, Merck does not allocate the remaining materials and production costs not included in segment profits as described above, research and development expenses incurred in Merck Research Laboratories, the Company’s research and development division that focuses on human health-related activities, or general and administrative expenses, nor the cost of financing these activities. Separate divisions maintain responsibility for monitoring and managing these costs, including depreciation related to fixed assets utilized by these divisions and, therefore, they are not included in segment profits. In addition, costs related to restructuring activities, as well as the amortization of purchase accounting adjustments are not allocated to segments.

Other profits are primarily comprised of miscellaneous corporate profits, as well as operating profits related to third-party manufacturing sales.

Other unallocated, net includes expenses from corporate and manufacturing cost centers, goodwill and intangible asset impairment charges, gains or losses on sales of businesses, expense or income related to changes in the estimated fair value of contingent consideration, and other miscellaneous income or expense items.

In the first quarter of 2018, the Company adopted a new accounting standard related to the classification of certain defined benefit plan costs (see Note 1), which resulted in a change to the measurement of segment profits. Net periodic benefit cost (credit) other than service cost is no longer included as a component of segment profits. Prior period amounts have been recast to conform to the new presentation.

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

Recent Developments

Business Developments

In June 2018, Merck acquired Viralytics Limited (Viralytics), an Australian publicly traded company focused on oncolytic immunotherapy treatments for a range of cancers, for AUD 502 million ($378 million). The transaction provided Merck with full rights to Cavatak (V937, formerly CVA21), Viralytics's investigational oncolytic immunotherapy. Cavatak is based on Viralytics's proprietary formulation of an oncolytic virus (Coxsackievirus Type A21) that has been shown to preferentially infect and kill cancer cells. Cavatak is currently being evaluated in multiple Phase 1 and Phase 2 clinical trials, both as an intratumoral and intravenous agent, including in combination with Keytruda (pembrolizumab). Under a previous agreement between Merck and Viralytics, a study is investigating the use of the Keytruda and Cavatak combination in melanoma, prostate, lung and bladder cancers.

In March 2018, Merck and Eisai Co., Ltd. (Eisai) announced a strategic collaboration for the worldwide co-development and co-commercialization of Lenvima (lenvatinib mesylate), an orally available tyrosine kinase inhibitor discovered by Eisai. Under the agreement, Merck and Eisai will develop and commercialize Lenvima jointly, both as monotherapy and in combination with Merck's anti-PD-1 therapy, Keytruda. Eisai records Lenvima product sales globally, as monotherapy and in combination, and Merck and Eisai share gross profits equally. Merck records its share of Lenvima product sales, net of cost of sales and commercialization costs, as alliance revenue. Expenses incurred during co-development, including for studies evaluating Lenvima as monotherapy, are shared equally by the two companies. Under the agreement, Merck made upfront payments to Eisai of $750 million and will make payments of up to $650 million for certain option rights through 2021 ($325 million in January 2019 or earlier in certain circumstances, $200 million in January 2020 and $125 million in January 2021). The Company recorded an aggregate charge of $1.4 billion in Research and development expenses in the first quarter of 2018 related to the upfront payments and future option payments. In addition, the agreement provides for Eisai to receive up to $385 million associated with the achievement of certain clinical and regulatory milestones and up to $3.97 billion for the achievement of milestones associated with sales of Lenvima. In March 2018, Lenvima was approved in Japan for unresectable hepatocellular carcinoma, which was the first regulatory approval under the global strategic collaboration, triggering a $25 million milestone payment to Eisai.

Cyber-attack

On June 27, 2017, the Company experienced a network cyber-attack that led to a disruption of its worldwide operations, including manufacturing, research and sales operations. All of the Company's manufacturing sites are now operational, manufacturing active pharmaceutical ingredient (API), formulating, packaging and shipping product. Due to a residual backlog of orders for certain products as a result of the cyber-attack, as anticipated, the Company was unable to fulfill orders for certain products in certain markets, which had an unfavorable effect on sales for the second quarter and first six months of 2018 of approximately $70 million and $145 million, respectively. The Company anticipates that sales for the full year of 2018 will be unfavorably affected in certain markets by approximately $200 million from the cyber-attack. In addition, the Company recorded manufacturing-related expenses, primarily unfavorable manufacturing variances, in Materials and production costs, as well as expenses related to remediation efforts in Marketing and administrative expenses and Research and development expenses, which aggregated approximately $25 million and $35 million for the second quarter and first six months of 2018, respectively, net of insurance recoveries of approximately $15 million.

As referenced above, the Company has insurance coverage insuring against costs resulting from cyber-attacks and has received insurance proceeds. However, there may be disputes with the insurers about the availability of the insurance coverage for claims related to this incident.

Additionally, the temporary production shut-down from the cyber-attack contributed to the Company's inability to meet higher than expected demand for Gardasil 9 (Human Papillomavirus 9-valent Vaccine, Recombinant), which resulted in Merck's decision to borrow doses of Gardasil 9 from the U.S. Centers for Disease Control and Prevention (CDC) Pediatric Vaccine Stockpile in 2017. The Company subsequently replenished a portion of the borrowed doses in 2017. The net effect of the borrowing and subsequent partial replenishment was a reduction in sales of $125 million

in 2017. The Company anticipates it will replenish the remaining borrowed doses in the second half of 2018.

Pricing

Global efforts toward health care cost containment continue to exert pressure on product pricing and market access worldwide. In the United States, pricing pressures continue on many of the Company's products. Changes to the U.S. health care system as part of health care reform, as well as increased purchasing power of entities that negotiate on behalf of Medicare, Medicaid, and private sector beneficiaries, could result in further pricing pressures. In July 2018, the Company announced its commitment not to increase the average net price in the United States across its human health portfolio of products by more than inflation annually.

In several international markets, government-mandated pricing actions have reduced prices of generic and patented drugs. In addition, other austerity measures negatively affected the Company's revenue performance in the first six months of 2018. The Company anticipates these pricing actions and other austerity measures will continue to negatively affect revenue performance for the remainder of 2018.

Operating Results

Sales

Worldwide sales were $10.5 billion for the second quarter of 2018, an increase of 5% compared with the second quarter of 2017 including a 1% favorable effect from foreign exchange. Global sales were $20.5 billion for the first six months of 2018, an increase of 6% compared with the same period of 2017 including a 2% favorable effect from foreign exchange. Sales growth in both periods was driven primarily by higher sales in the oncology franchise reflecting strong growth of Keytruda, the Company's anti-PD-1 (programmed death receptor-1) therapy, as well as alliance revenue related to Lynparza (olaparib) and Lenvima. Also contributing to revenue growth were higher sales in the hospital acute care franchise, largely attributable to Bridion (sugammadex) Injection and Noxafil (posaconazole), as well as higher sales of vaccines, primarily human papillomavirus (HPV) vaccine Gardasil (Human Papillomavirus Quadrivalent [Types 6, 11, 16 and 18] Vaccine, Recombinant)/Gardasil 9. Additionally, higher sales of animal health products also contributed to revenue growth in the second quarter and first six months of 2018.

These increases were partially offset by declines in the virology franchise driven primarily by lower sales of hepatitis C virus (HCV) treatment Zepatier (elbasvir and grazoprevir), as well as lower sales of Zostavax (Zoster Vaccine Live). The ongoing effects of generic and biosimilar competition for cardiovascular products Zetia (ezetimibe), Vytorin (ezetimibe and simvastatin), and immunology product Remicade (infliximab), as well as lower sales of products within the diversified brands franchise also partially offset revenue growth in the quarter and year-to-date period. The diversified brands franchise includes certain products approaching the expiration of their marketing exclusivity or that are no longer protected by patents in developed markets.

Sales of the Company's products were as follows:

	Three Months Ended June 30,						Six Months Ended June 30,					
	2018			2017			2018			2017		
($ in millions)	U.S.	Int'l	Total	U.S.	Int'l	Total	U.S.	Int'l	Total	U.S.	Int'l	Total
Pharmaceutical:												
Oncology												
Keytruda	$959	$707	$1,667	$556	$325	$881	$1,797	$1,333	$3,131	$917	$547	$1,465
Emend	89	59	148	83	60	143	168	105	273	169	107	276
Temodar	1	54	56	3	61	65	2	111	113	4	126	130
Alliance revenue - Lynparza	31	13	44	—	—	—	55	22	76	—	—	—
Alliance revenue - Lenvima	—	35	35	—	—	—	—	35	35	—	—	—
Vaccines												
Gardasil/Gardasil 9	302	306	608	312	156	469	682	586	1,269	711	290	1,001
ProQuad/M-M-R II/Varivax	356	70	426	341	58	399	668	150	818	639	115	754
Pneumovax 23	122	71	193	104	61	166	234	137	372	219	110	329
RotaTeq	99	57	156	72								