Merck & Co. Inc.
Form 10-Q
November 08, 2011

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2011

OR

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

For the transition period from _____ to _____

Commission File No. 1-6571

Merck & Co., Inc.

One Merck Drive
Whitehouse Station, N.J. 08889-0100
(908) 423-1000

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

The number of shares of common stock outstanding as of the close of business on October 31, 2011: 3,047,921,407

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 þ No o

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 þ No o

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

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o	Smaller reporting company o

(Do not check if a smaller reporting company)

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

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Part I Financial Information
Item 1. Financial Statements

MERCK & CO., INC. AND SUBSIDIARIES
INTERIM CONSOLIDATED STATEMENT OF INCOME
(Unaudited, $ in millions except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Sales	$ 12,022	$ 11,125	$ 35,753	$ 33,893
Costs, Expenses and Other				
Materials and production	4,352	4,191	12,695	13,956
Marketing and administrative	3,340	3,192	10,029	9,589
Research and development	1,954	2,322	6,048	6,552
Restructuring costs	119	50	773	864
Equity income from affiliates	(161)	(236)	(354)	(417)
Other (income) expense, net	66	1,108	809	995
	9,670	10,627	30,000	31,539
Income Before Taxes	2,352	498	5,753	2,354
Taxes on Income	628	126	904	872
Net Income	$ 1,724	$ 372	$ 4,849	$ 1,482
Less: Net Income Attributable to Noncontrolling Interests	32	30	89	89
Net Income Attributable to Merck & Co., Inc.	$ 1,692	$ 342	$ 4,760	$ 1,393
Basic Earnings per Common Share Attributable to Merck & Co., Inc. Common Shareholders	$ 0.55	$ 0.11	$ 1.54	$ 0.45
Earnings per Common Share Assuming Dilution Attributable to Merck & Co., Inc. Common Shareholders	$ 0.55	$ 0.11	$ 1.53	$ 0.44
Dividends Declared per Common Share	$ 0.38	$ 0.38	$ 1.14	$ 1.14

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

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

	September 30, 2011	December 31, 2010
Assets		
Current Assets		
Cash and cash equivalents	$ 14,253	$ 10,900
Short-term investments	1,323	1,301
Accounts receivable (net of allowance for doubtful accounts of $129 in 2011 and $104 in 2010)	8,136	7,344
Inventories (excludes inventories of $1,382 in 2011 and $1,194 in 2010 classified in Other assets see Note 6)	6,239	5,868
Deferred income taxes and other current assets	4,158	3,651
Total current assets	34,109	29,064
Investments	2,423	2,175
Property, Plant and Equipment, at cost, net of accumulated depreciation of $15,674 in 2011 and $13,481 in 2010	16,383	17,082
Goodwill	12,228	12,378
Other Intangibles, Net	35,822	39,456
Other Assets	5,569	5,626
	$ 106,534	$ 105,781
Liabilities and Equity		
Current Liabilities		
Loans payable and current portion of long-term debt	$ 2,455	$ 2,400
Trade accounts payable	2,282	2,308
Accrued and other current liabilities	9,228	8,514
Income taxes payable	1,462	1,243
Dividends payable	1,166	1,176
Total current liabilities	16,593	15,641
Long-Term Debt	15,692	15,482
Deferred Income Taxes and Noncurrent Liabilities	16,653	17,853

Merck & Co., Inc. Stockholders Equity		
Common stock, $0.50 par value		
Authorized - 6,500,000,000 shares		.
Issued - 3,576,948,356 shares in 2011 and 2010	1,788	1,788
Other paid-in capital	40,717	40,701
Retained earnings	38,763	37,536
Accumulated other comprehensive loss	(2,713)	(3,216)
	78,555	76,809
Less treasury stock, at cost 525,000,622 shares in 2011 and 494,841,533 shares in 2010	23,415	22,433
Total Merck & Co., Inc. stockholders equity	55,140	54,376
Noncontrolling Interests	2,456	2,429
Total equity	57,596	56,805
	$ 106,534	$ 105,781

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

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

	Nine Months Ended September 30,	
	2011	2010
Cash Flows from Operating Activities		
Net income	$ 4,849	$ 1,482
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	5,566	5,515
Intangible asset impairment charges	461	216
Equity income from affiliates	(354)	(417)
Dividends and distributions from equity affiliates	186	264
Gain on AstraZeneca asset option exercise		(443)
Deferred income taxes	(974)	(743)
Share-based compensation	287	400
Other	(207)	227
Net changes in assets and liabilities	(664)	782
Net Cash Provided by Operating Activities	9,150	7,283
Cash Flows from Investing Activities		
Capital expenditures	(1,120)	(1,018)
Purchases of securities and other investments	(4,686)	(5,826)
Proceeds from sales of securities and other investments	4,740	3,726
Dispositions of businesses, net of cash divested	323	
Acquisitions of businesses, net of cash acquired	(373)	(152)
Proceeds from AstraZeneca option exercise		647
Other	(90)	133
Net Cash Used in Investing Activities	(1,206)	(2,490)
Cash Flows from Financing Activities		
Net change in short-term borrowings	1,356	1,573
Payments on debt	(1,277)	(689)
Purchases of treasury stock	(1,359)	(1,593)
Dividends paid to stockholders	(3,526)	(3,559)
Proceeds from exercise of stock options	194	313
Other	(61)	(191)
Net Cash Used in Financing Activities	(4,673)	(4,146)
Effect of Exchange Rate Changes on Cash and Cash Equivalents	82	(84)

Net Increase in Cash and Cash Equivalents	3,353	563
Cash and Cash Equivalents at Beginning of Year	10,900	9,311
Cash and Cash Equivalents at End of Period	$ 14,253	$ 9,874

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

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Notes to Consolidated Financial Statements (unaudited)

1. Basis of Presentation

The accompanying unaudited interim consolidated financial statements 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 & Co., Inc. s Form 10-K filed on February 28, 2011.

On November 3, 2009, Merck & Co., Inc. (Old Merck) and Schering-Plough Corporation (Schering-Plough) merged (the Merger). In the Merger, Schering-Plough acquired all of the shares of Old Merck, which became a wholly owned subsidiary of Schering-Plough and was renamed Merck Sharp & Dohme Corp. Schering-Plough continued as the surviving public company and was renamed Merck & Co., Inc. (New Merck or the Company). However, for accounting purposes only, the Merger was treated as an acquisition with Old Merck considered the accounting acquirer. References in these financial statements to Merck for periods prior to the Merger refer to Old Merck and for periods after the completion of the Merger to New Merck.

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

Certain reclassifications have been made to prior year amounts to conform to the current year presentation.

Recently Adopted Accounting Standards

In October 2009, the Financial Accounting Standards Board (FASB) issued new guidance for revenue recognition with multiple deliverables. The Company adopted this guidance prospectively for revenue arrangements entered into or materially modified on or after January 1, 2011. This guidance eliminates the residual method under the current guidance and replaces it with the relative selling price method when allocating revenue in a multiple deliverable arrangement. The selling price for each deliverable shall be determined using vendor specific objective evidence of selling price, if it exists, otherwise third-party evidence of selling price shall be used. If neither exists for a deliverable, the vendor shall use its best estimate of the selling price for that deliverable. The effect of adoption on the Company s financial position and results of operations was not material.

Recently Issued Accounting Standards

In June 2011, the FASB issued amended guidance on the presentation of comprehensive income in financial statements. This amendment provides companies the option to present the components of net income and other comprehensive income either as one continuous statement of comprehensive income or as two separate but consecutive statements. It eliminates the option to present components of other comprehensive income as part of the statement of changes in stockholders equity. The provisions of this new guidance are effective for interim and annual periods beginning in 2012 although earlier adoption is permitted. The adoption of this new guidance will not impact the Company s financial position, results of operations or cash flows.

In September 2011, the FASB issued amended guidance that simplifies how an entity tests goodwill for impairment. The amended guidance will allow companies to first assess qualitative factors to determine if it is more-likely-than-not that the fair value of a reporting unit is less than its carrying value and whether to perform the two-step goodwill impairment test. The updated guidance is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011, with early adoption permitted. On October 1, 2011, the Company early adopted the amended guidance in conjunction with its annual impairment testing.

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Notes to Consolidated Financial Statements (unaudited) (continued)

2. Restructuring

Merger Restructuring Program

In February 2010, the Company commenced actions under a global restructuring program (the Merger Restructuring Program) in conjunction with the integration of the legacy Merck and legacy Schering-Plough businesses. This Merger Restructuring Program is intended to optimize the cost structure of the combined company. Additional actions under the program continued during 2010. On July 29, 2011, the Company announced the latest phase of the Merger Restructuring Program during which the Company expects to reduce its workforce measured at the time of the Merger by an additional 12% to 13% across the Company worldwide. A majority of the workforce reductions in this phase of the Merger Restructuring Program relate to manufacturing (including Animal Health), administrative and headquarters organizations. Previously announced workforce reductions of approximately 17% in earlier phases of the program primarily reflect the elimination of positions in sales, administrative and headquarters organizations, as well as from the sale or closure of certain manufacturing and research and development sites and the consolidation of office facilities. The Company will continue to hire employees in strategic growth areas of the business as necessary. The Company will continue to pursue productivity efficiencies and evaluate its manufacturing supply chain capabilities on an ongoing basis which may result in future restructuring actions.

The Company recorded total pretax restructuring costs of $255 million and $384 million in the third quarter of 2011 and 2010, respectively, and $1.2 billion and $1.5 billion for the first nine months of 2011 and 2010, respectively, related to this program. Since inception of the Merger Restructuring Program through September 30, 2011, Merck has recorded total pretax accumulated costs of approximately $4.5 billion and eliminated approximately 14,200 positions comprised of employee separations, as well as the elimination of contractors and more than 2,500 positions that were vacant at the time of the Merger. The restructuring actions under the Merger Restructuring Program are expected to be substantially completed by the end of 2013, with the exception of certain actions, principally manufacturing-related, which are expected to be completed by 2015, with the total cumulative pretax costs estimated to be approximately $5.8 billion to $6.6 billion. The Company estimates that approximately two-thirds of the cumulative pretax costs relate to cash outlays, primarily related to employee separation expense. Approximately one-third of the cumulative pretax costs are non-cash, relating primarily to the accelerated depreciation of facilities to be closed or divested.

2008 Global Restructuring Program

In October 2008, Old Merck announced a global restructuring program (the 2008 Restructuring Program) to reduce its cost structure, increase efficiency, and enhance competitiveness. As part of the 2008 Restructuring Program, the Company expects to eliminate approximately 7,200 positions 6,800 active employees and 400 vacancies across the Company worldwide. Pretax restructuring costs of $20 million were recorded in the third quarter of 2011 and $25 million and $130 million in the first nine months of 2011 and 2010, respectively, related to the 2008 Restructuring Program. Since inception of the 2008 Restructuring Program through September 30, 2011, Merck has recorded total pretax accumulated costs of $1.6 billion and eliminated approximately 6,090 positions comprised of employee separations and the elimination of contractors and vacant positions. The 2008 Restructuring Program is expected to be completed by the end of 2011, with the exception of certain manufacturing-related actions, with the total cumulative pretax costs estimated to be up to $2.0 billion. The Company estimates that two-thirds of the cumulative pretax costs relate to cash outlays, primarily from employee separation expense. Approximately one-third of the cumulative pretax costs are non-cash, relating primarily to the accelerated depreciation of facilities to be closed or divested.

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Notes to Consolidated Financial Statements (unaudited) (continued)

For segment reporting, restructuring charges are unallocated expenses.

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

	Three Months Ended September 30, 2011				Nine Months Ended September 30, 2011			
($ in millions)	Separation Costs	Accelerated Depreciation	Other	Total	Separation Costs	Accelerated Depreciation	Other	Total
Merger Restructuring Program								
Materials and production	$	$ 81	$ 7	$ 88	$	$ 233	$ 12	$ 245
Marketing and administrative		22	9	31		67	10	77
Research and development		27	1	28		107	(18)	89
Restructuring costs	63		45	108	670		95	765
	63	130	62	255	670	407	99	1,176
2008 Restructuring Program								
Materials and production		10	(1)	9		16	1	17
Restructuring costs	5		6	11	(3)		11	8
	5	10	5	20	(3)	16	12	25
	$ 68	$ 140	$ 67	$ 275	$ 667	$ 423	$ 111	$ 1,201

	Three Months Ended September 30, 2010				Nine Months Ended September 30, 2010			
($ in millions)	Separation Costs	Accelerated Depreciation	Other	Total	Separation Costs	Accelerated Depreciation	Other	Total
Merger Restructuring Program								
Materials and production	$	$ 13[1]	$ 41[2]	$ 54	$	$ 188	$ 62	$ 250
Marketing and administrative		123[1]	11	134		123	11	134
Research and development		153		153		266	37	303
Restructuring costs	67	(41)[1]	17	43	650		160	810
	67	248	69	384	650	577	270	1,497
2008 Restructuring Program								
Materials and production		19	(33)[2]	(14)		59	3	62
Marketing and administrative			(4)	(4)			(4)	(4)

Research and development		10		10		10		10
Restructuring costs	10		(3)	7	41		21	62
	10	29	(40)	(1)	41	69	20	130
	$ 77	$ 277	$ 29	$ 383	$ 691	$ 646	$ 290	$ 1,627

(1) *Amounts reflect third quarter reclassifications of certain accelerated depreciation charges, recorded in the second quarter, from* Materials and production *and* Restructuring costs *to* Marketing and administrative.

(2) *Reflects the reclassification of a second quarter $36 million charge from the 2008 Restructuring Program to the Merger Restructuring Program.*

Separation costs are associated with actual headcount reductions, as well as those headcount reductions which were probable and could be reasonably estimated. In the first nine months of 2011, separation costs for the Merger Restructuring Program include a reduction of separation reserves of approximately $50 million resulting from the Company s decision in the first quarter to retain approximately 380 employees at its Oss, Netherlands research facility that had previously been expected to be separated. In the third quarter of 2011 and 2010, approximately 1,300 positions and 2,175 positions, respectively, were eliminated under the Merger Restructuring Program and approximately 110 positions and 180 positions, respectively, were eliminated under the 2008 Restructuring Program. In the first nine months of 2011 and 2010, approximately 2,635 positions and 9,760 positions, respectively, were eliminated under the Merger Restructuring Program and approximately 290 positions and 955 positions, respectively, were eliminated under the 2008 Restructuring Program. These position eliminations were comprised of actual headcount reductions and the elimination of contractors and vacant positions.

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

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Notes to Consolidated Financial Statements (unaudited) (continued)

Other activity in 2011 and 2010 includes asset abandonment, shut-down and other related costs. Additionally, other activity includes employee-related costs such as curtailment, settlement and termination charges associated with pension and other postretirement benefit plans (see Note 12) and share-based compensation costs.

The following table summarizes the charges and spending relating to Merger Restructuring Program and 2008 Restructuring Program activities for the nine months ended September 30, 2011:

($ in millions)	Separation Costs	Accelerated Depreciation	Other	Total
Merger Restructuring Program				
Restructuring reserves January 1, 2011	$ 859	$	$ 64	$ 923
Expense	670	407	99	1,176
(Payments) receipts, net	(417)		(121)	(538)
Non-cash activity		(407)	7	(400)
Restructuring reserves September 30, 2011 [(1)]	$ 1,112	$	$ 49	$ 1,161
2008 Restructuring Program				
Restructuring reserves January 1, 2011	$ 196	$	$	$ 196
Expense	(3)	16	12	25
(Payments) receipts, net	(53)		(11)	(64)
Non-cash activity		(16)	(1)	(17)
Restructuring reserves September 30, 2011 [(1)]	$ 140	$	$	$ 140

[(1)] *The cash outlays associated with the Merger Restructuring Program and the 2008 Restructuring Program are expected to be substantially completed by the end of 2013 and 2011, respectively, with the exception of certain actions, principally manufacturing-related, which are expected to be completed by 2015.*

Legacy Schering-Plough Program

Prior to the Merger, Schering-Plough commenced a Productivity Transformation Program which was designed to reduce and avoid costs and increase productivity. The Company recorded accelerated depreciation costs included in *Materials and production* of $2 million and $4 million for the third quarter of 2011 and 2010, respectively, and $18 million and $13 million for the first nine months of 2011 and 2010, respectively. In addition, the first nine months of 2010 includes a net gain of $8 million reflected in *Restructuring costs* primarily related to the sale of a manufacturing facility. The remaining reserve associated with this program was $30 million at September 30, 2011.

3. Acquisitions, Divestitures, Research Collaborations and License Agreements

In May 2011, Merck completed the acquisition of Inspire Pharmaceuticals, Inc. (Inspire), a specialty pharmaceutical company focused on developing and commercializing ophthalmic products. Under the terms of the merger agreement, Merck acquired all outstanding shares of common stock of Inspire at a price of $5.00 per share in cash for a total of approximately $420 million. The transaction was accounted for as an acquisition of a business; accordingly, the assets acquired and liabilities assumed were recorded at their respective fair values as of the acquisition date. The determination of fair value requires management to make significant estimates and assumptions. In connection with the acquisition, substantially all of the purchase price was allocated to Inspire s product and product right intangible assets and related deferred tax liabilities, a deferred tax asset relating to Inspire s net operating loss carryforwards, and goodwill. Certain estimated values are not yet finalized and may be subject to change. The

Company expects to finalize these amounts as soon as possible, but no later than one year from the acquisition date. This transaction closed on May 16, 2011, and accordingly, the results of operations of the acquired business have been included in the Company s results of operations beginning after the acquisition date. Pro forma financial information has not been included because Inspire s historical financial results are not significant when compared with the Company s financial results.

In March 2011, the Company sold the Merck BioManufacturing Network, a leading provider of contract manufacturing and development services for the biopharmaceutical industry and wholly owned by Merck, to Fujifilm Corporation (Fujifilm). Under the terms of the agreement, Fujifilm purchased all of the equity interests in two Merck subsidiaries which together own all assets of the Merck BioManufacturing Network comprising

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Notes to Consolidated Financial Statements (unaudited) (continued)

facilities located in Research Triangle Park, North Carolina and Billingham, U.K.; and including manufacturing contracts; business support operations and a highly skilled workforce. As part of the agreement with Fujifilm, Merck has committed to certain continued development and manufacturing activities with these two companies. The transaction resulted in a gain of $127 million in the first nine months of 2011 reflected in *Other (income) expense, net.*

4. Collaborative Arrangements

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

Cozaar/Hyzaar

In 1989, Old Merck and E.I. duPont de Nemours and Company (DuPont) agreed to form a long-term research and marketing collaboration to develop a class of therapeutic agents for high blood pressure and heart disease, discovered by DuPont, called angiotensin II receptor antagonists, which include *Cozaar* and *Hyzaar*. In return, Old Merck provided DuPont marketing rights in the United States and Canada to its prescription medicines, *Sinemet* and *Sinemet CR* (the Company has since regained global marketing rights to *Sinemet* and *Sinemet CR*). Pursuant to a 1994 agreement with DuPont, the Company has an exclusive licensing agreement to market *Cozaar* and *Hyzaar* in return for royalties and profit share payments to DuPont. The patents that provided market exclusivity in the United States for *Cozaar* and *Hyzaar* expired in April 2010. In addition, *Cozaar* and *Hyzaar* lost patent protection in a number of major European markets in March 2010.

Remicade/Simponi

In 1998, a subsidiary of Schering-Plough entered into a licensing agreement with Centocor Ortho Biotech Inc. (Centocor), a Johnson & Johnson (J&J) company, to market *Remicade,* which is prescribed for the treatment of inflammatory diseases. In 2005, Schering-Plough s subsidiary exercised an option under its contract with Centocor for license rights to develop and commercialize *Simponi* (golimumab), a fully human monoclonal antibody. The Company had exclusive marketing rights to both products outside the United States, Japan and certain other Asian markets. In December 2007, Schering-Plough and Centocor revised their distribution agreement regarding the development, commercialization and distribution of both *Remicade* and *Simponi*, extending the Company s rights to exclusively market *Remicade* to match the duration of the Company s exclusive marketing rights for *Simponi*. In addition, Schering-Plough and Centocor agreed to share certain development costs relating to *Simponi s* auto-injector delivery system. On October 6, 2009, the European Commission approved *Simponi* as a treatment for rheumatoid arthritis and other immune system disorders in two presentations a novel auto-injector and a prefilled syringe. As a result, the Company s marketing rights for both products extend for 15 years from the first commercial sale of *Simponi* in the European Union (EU) following the receipt of pricing and reimbursement approval within the EU. In April 2011, Merck and J&J reached agreement to amend the distribution rights to *Remicade* and *Simponi*. Under the terms of the amended distribution agreement, Merck relinquished exclusive marketing rights for *Remicade* and *Simponi* to J&J in territories including Canada, Central and South America, the Middle East, Africa and Asia Pacific effective July 1, 2011. Merck retained exclusive marketing rights throughout Europe, Russia and Turkey (Retained Territories). In addition, beginning July 1, 2011, all profit derived from Merck s exclusive distribution of the two products in the Retained Territories is being equally divided between Merck and J&J. Under the prior terms of the distribution agreement, the contribution income (profit) split, which was at 58% to Merck and 42% percent to J&J, would have declined for Merck and increased for J&J each year until 2014, when it would have been equally divided. J&J also received a one-time payment of $500 million in April 2011, which the Company recorded as a charge to *Other (income) expense, net* in the first quarter of 2011.

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Notes to Consolidated Financial Statements (unaudited) (continued)

5. 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

A significant portion of the Company s revenues are denominated in foreign currencies. The Company has established revenue hedging and balance sheet risk management programs to protect against volatility of future foreign currency cash flows and changes in fair value caused by volatility in foreign exchange rates.

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

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

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

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Notes to Consolidated Financial Statements (unaudited) (continued)

The fair values of these derivative contracts are recorded as either assets (gain positions) or liabilities (loss positions) in the Consolidated Balance Sheet. Changes in the fair value of derivative contracts are recorded each period in either current earnings or *Other comprehensive income* (*OCI*), depending on whether the derivative is designated as part of a hedge transaction and, if so, the type of hedge transaction. For derivatives that are designated as cash flow hedges, the effective portion of the unrealized gains or losses on thes