Zoetis Inc.
Form 10-Q
August 08, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended July 2, 2017
or
TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

¨ For the transition period from _____ to _____
Commission File Number: 001-35797
Zoetis Inc.
(Exact name of registrant as specified in its charter)

Delaware	46-0696167
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
10 Sylvan Way, Parsippany, New Jersey	07054
(Address of principal executive offices)	(Zip Code)

(973) 822-7000
(Registrant's telephone number, including area code)

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 and 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. x 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). x Yes ¨ No
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, non-accelerated filer, smaller reporting company or an emerging growth company. See 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 x	Accelerated filer ¨	Non-accelerated filer ¨	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 x No
At August 2, 2017, there were 489,111,671 shares of common stock outstanding.

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PART I – FINANCIAL INFORMATION
Item 1. Financial Statements

ZOETIS INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS AND SHARES, EXCEPT PER SHARE DATA)	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Revenue	$1,269	$1,208	$2,500	$2,370
Costs and expenses:				
Cost of sales[(a)]	440	399	883	788
Selling, general and administrative expenses[(a)]	336	343	645	658
Research and development expenses[(a)]	86	88	176	178
Amortization of intangible assets[(a)]	23	22	45	43
Restructuring charges/(reversals) and certain acquisition-related costs	—	(21)	(1)	(19)
Interest expense, net of capitalized interest	41	41	82	84
Other (income)/deductions—net	(2)	4	(12)	(26)
Income before provision for taxes on income	345	332	682	664
Provision for taxes on income	98	108	196	236
Net income before allocation to noncontrolling interests	247	224	486	428
Less: Net income attributable to noncontrolling interests	—	—	1	—
Net income attributable to Zoetis Inc.	$247	$224	$485	$428
Earnings per share attributable to Zoetis Inc. stockholders:				
Basic	$0.50	$0.45	$0.99	$0.86
Diluted	$0.50	$0.45	$0.98	$0.86
Weighted-average common shares outstanding:				
Basic	490.8	496.3	491.6	496.9
Diluted	494.0	498.8	494.6	499.2
Dividends declared per common share	$0.105	$0.095	$0.210	$0.190

(a) Amortization expense related to finite-lived acquired intangible assets that contribute to our ability to sell, manufacture, research, market and distribute products, compounds and intellectual property is included in Amortization of intangible assets as these intangible assets benefit multiple business functions. Amortization expense related to finite-lived acquired intangible assets that are associated with a single function is included in Cost of sales, Selling, general and administrative expenses or Research and development expenses, as appropriate, in the condensed consolidated statements of income.

See notes to condensed consolidated financial statements.

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ZOETIS INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Net income before allocation to noncontrolling interests	$247	$224	$486	$428
Other comprehensive income/(loss), net of taxes and reclassification adjustments:				
Unrealized losses on derivatives, net[(a)]	(1)	(3)	(1)	(3)
Foreign currency translation adjustments, net	12	63	56	65
Benefit plans: Actuarial (losses)/gains, net[(a)]	(1)	2	1	3
Total other comprehensive income/(loss), net of tax	10	62	56	65
Comprehensive income before allocation to noncontrolling interests	257	286	542	493
Less: Comprehensive income/(loss) attributable to noncontrolling interests	—	—	1	(1)
Comprehensive income attributable to Zoetis Inc.	$257	$286	$541	$494

(a) Presented net of reclassification adjustments and tax impacts, which are not significant in any period presented. Reclassification adjustments related to benefit plans are generally reclassified, as part of net periodic pension cost, into Cost of sales, Selling, general and administrative expenses, and/or Research and development expenses, as appropriate, in the condensed consolidated statements of income.

See notes to condensed consolidated financial statements.

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ZOETIS INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

(MILLIONS OF DOLLARS, EXCEPT SHARE AND PER SHARE DATA)	July 2, 2017 (Unaudited)	December 31, 2016
Assets		
Cash and cash equivalents[(a)]	$ 705	$ 727
Accounts receivable, less allowance for doubtful accounts of $31 in 2017 and $30 in 2016	975	913
Inventories	1,498	1,502
Assets held for sale	53	—
Other current assets	353	248
Total current assets	3,584	3,390
Property, plant and equipment, less accumulated depreciation of $1,397 in 2017 and $1,358 in 2016	1,355	1,381
Goodwill	1,495	1,481
Identifiable intangible assets, less accumulated amortization	1,210	1,228
Deferred tax assets	93	96
Other noncurrent assets	65	73
Total assets	$ 7,802	$ 7,649
Liabilities and Equity		
Short-term borrowings	$ 100	$ —
Current portion of long-term debt	750	$ —
Accounts payable	199	265
Dividends payable	52	52
Accrued expenses	406	464
Accrued compensation and related items	163	224
Income taxes payable	82	71
Liabilities associated with assets held for sale	4	—
Other current liabilities	28	41
Total current liabilities	1,784	1,117
Long-term debt, net of discount and issuance costs	3,719	4,468
Deferred tax liabilities	261	244
Other taxes payable	83	73
Other noncurrent liabilities	209	248
Total liabilities	6,056	6,150
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.01 par value: 1,000,000,000 authorized, none issued	—	—
Common stock, $0.01 par value: 6,000,000,000 authorized; 501,891,243 and 501,891,243 shares issued; 489,659,511 and 492,855,297 shares outstanding at July 2, 2017, and December 31, 2016, respectively	5	5
Treasury stock, at cost, 12,231,732 and 9,035,946 shares of common stock at July 2, 2017, and December 31, 2016, respectively	(615)	(421)
Additional paid-in capital	1,024	1,024
Retained earnings	1,843	1,477
Accumulated other comprehensive loss	(542)	(598)

Total Zoetis Inc. equity	1,715	1,487
Equity attributable to noncontrolling interests	31	12
Total equity	1,746	1,499
Total liabilities and equity	$ 7,802	$ 7,649

[a] As of July 2, 2017, includes $7 million of restricted cash.

See notes to condensed consolidated financial statements.

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ZOETIS INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF EQUITY
(UNAUDITED)

(MILLIONS OF DOLLARS)	Zoetis Common Stock[a]	Treasury Stock[a]	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Equity Attributable to Noncontrolling Interests	Total Equity
Balance, December 31, 2015	$ 5	$ (203)	$ 1,012	$ 876	$ (622)	$ 23	$ 1,091
Six months ended July 3, 2016							
Net income	—	—	—	428	—	—	428
Other comprehensive income/(loss)	—	—	—	—	66	(1)	65
Share-based compensation awards[b]	—	60	(3)	(20)	—	—	37
Treasury stock acquired[c]	—	(151)	—	—	—	—	(151)
Employee benefit plan contribution from Pfizer Inc.[d]	—	—	1	—	—	—	1
Divestitures[e]	—	—	—	—	2	(8)	(6)
Dividends declared	—	—	—	(94)	—	—	(94)
Balance, July 3, 2016	$ 5	$ (294)	$ 1,010	$ 1,190	$ (554)	$ 14	$ 1,371
Balance, December 31, 2016	$ 5	$ (421)	$ 1,024	$ 1,477	$ (598)	$ 12	$ 1,499
Six months ended July 2, 2017							
Net income	—	—	—	485	—	1	486
Other comprehensive income	—	—	—	—	56	—	56
Consolidation of a noncontrolling interest[f]	—	—	—	—	—	18	18
Share-based compensation awards [b]	—	56	(1)	(16)	—	—	39
Treasury stock acquired[c]	—	(250)	—	—	—	—	(250)
Employee benefit plan contribution from Pfizer Inc.[d]	—	—	1	—	—	—	1
Dividends declared	—	—	—	(103)	—	—	(103)
Balance, July 2, 2017	$ 5	$ (615)	$ 1,024	$ 1,843	$ (542)	$ 31	$ 1,746

(a) As of July 2, 2017, and July 3, 2016, there were 489,659,511 and 495,389,702 outstanding shares of common stock, respectively, and 12,231,732 and 6,501,541 shares of treasury stock, respectively. Treasury stock is recognized at the cost to reacquire the shares. For additional information, see Note 13. Stockholders' Equity.

(b) Includes the issuance of shares of Zoetis Inc. common stock and the reissuance of treasury stock in connection with the vesting of employee share-based awards. Upon reissuance of treasury stock, differences between the proceeds from reissuance and the cost of the treasury stock that result in gains are recorded in Additional paid-in capital. Losses are recorded in Additional paid-in capital to the extent that they can offset previously recorded gains. If no such credit exists, the differences are recorded in Retained earnings. Also includes the reacquisition of shares of treasury stock associated with the vesting of employee share-based awards to satisfy tax withholding requirements. For additional information, see Note 12. Share-Based Payments and Note. 13. Stockholders' Equity.

(c) Reflects the acquisition of treasury shares in connection with the share repurchase program. For additional information, see Note 13. Stockholders' Equity.

(d) Represents contributed capital from Pfizer Inc. associated with service credit continuation for certain Zoetis Inc. employees in Pfizer Inc.'s U.S. qualified defined benefit and U.S. retiree medical plans. See Note 11. Benefit Plans.

(e) Reflects the divestiture of our share of our Taiwan joint venture. See Note 4. Acquisitions and Divestitures: Divestitures.

(f) Represents the consolidation of a European livestock monitoring company, a variable interest entity of which Zoetis is the primary beneficiary.

See notes to condensed consolidated financial statements.

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ZOETIS INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

(MILLIONS OF DOLLARS)	Six Months Ended July 2, 2017	July 3, 2016
Operating Activities		
Net income before allocation to noncontrolling interests	$486	$428
Adjustments to reconcile net income before noncontrolling interests to net cash provided by operating activities:		
Depreciation and amortization expense	121	117
Share-based compensation expense	22	19
Restructuring	(1)	(19)
Net loss/(gain) on sale of assets	2	(27)
Provision for losses on inventory	40	35
Deferred taxes	13	17
Employee benefit plan contribution from Pfizer Inc.	1	1
Other non-cash adjustments	—	9
Other changes in assets and liabilities, net of acquisitions and divestitures		
Accounts receivable	(41)	53
Inventories	(46)	(87)
Other assets	(106)	(72)
Accounts payable	(66)	(71)
Other liabilities	(147)	(254)
Other tax accounts, net	21	39
Net cash provided by operating activities	299	188
Investing Activities		
Purchases of property, plant and equipment	(93)	(99)
Acquisitions	(3)	(20)
Net proceeds from sales of assets	1	88
Other investing activities	7	—
Net cash used in investing activities	(88)	(31)
Financing Activities		
Decrease in short-term borrowings, net	—	(1)
Issuance of commercial paper	100	—
Principal payments on long-term debt	—	(400)
Payment of contingent consideration related to previously acquired assets	(5)	(22)
Share-based compensation-related proceeds, net of taxes paid on withholding shares	18	17
Purchases of treasury stock[(a)]	(250)	(151)
Cash dividends paid	(103)	(94)
Net cash used in financing activities	(240)	(651)
Effect of exchange-rate changes on cash and cash equivalents	7	(2)
Net decrease in cash and cash equivalents	(22)	(496)
Cash and cash equivalents at beginning of period	727	1,154
Cash and cash equivalents at end of period	$705	$658

Supplemental cash flow information

Cash paid during the period for:		
Income taxes	$256	$215
Interest, net of capitalized interest	82	84
Non-cash transactions:		
Purchases of property, plant and equipment	3	6
Contingent purchase price consideration[(b)]	—	27
Dividends declared, not paid	52	47

(a) Reflects the acquisition of treasury shares in connection with the share repurchase programs. For additional information, see Note 13. Stockholders' Equity.

(b) For 2016, relates primarily to the non-cash portion of the acquisition of a livestock business in South America.

See notes to condensed consolidated financial statements.

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ZOETIS INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. Organization

Zoetis Inc. (including its subsidiaries, collectively, Zoetis, the company, we, us or our) is a global leader in the discovery, development, manufacture and commercialization of animal health medicines and vaccines, with a focus on both livestock and companion animals. We organize and operate our business in two geographic regions: the United States (U.S.) and International.

We directly market our products in approximately 45 countries across North America, Europe, Africa, Asia, Australia and South America. Our products are sold in more than 100 countries, including developed markets and emerging markets. We have a diversified business, marketing products across eight core species: cattle, swine, poultry, sheep and fish (collectively, livestock) and dogs, cats and horses (collectively, companion animals); and within five major product categories: anti-infectives, vaccines, parasiticides, medicated feed additives and other pharmaceuticals.

2. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements were prepared following the requirements of the Securities and Exchange Commission (SEC) for interim reporting. As permitted under those rules, certain footnotes or other financial information that are normally required by accounting principles generally accepted in the United States of America (U.S. GAAP) can be condensed or omitted. Balance sheet amounts and operating results for subsidiaries operating outside the United States are as of and for the three and six-month periods ended May 28, 2017, and May 29, 2016.

Revenue, expenses, assets and liabilities can vary during each quarter of the year. Therefore, the results and trends in these interim financial statements may not be representative of those for the full year.

We are responsible for the unaudited condensed consolidated financial statements included in this Form 10-Q. The condensed consolidated financial statements include all normal and recurring adjustments that are considered necessary for the fair presentation of our financial position and operating results. The information included in this interim report should be read in conjunction with the financial statements and accompanying notes included in our 2016 Annual Report on Form 10-K.

3. Significant Accounting Policies

Recently Adopted Accounting Standards

In January 2017, the Financial Accounting Standards Board (FASB) issued an accounting standards update which clarifies the definition of a business. Under the new guidance, a set of integrated activities and assets is a business only if it has, at a minimum, an input and substantive process that together significantly contribute to the ability to create outputs. The update also introduces the concept of an initial screening or “Step 1” which requires companies to first determine if substantially all of the fair value of the gross assets acquired is concentrated in a single (or group of similar) identifiable assets. Transactions that pass the Step 1 screening will be considered a business if they contain an input and substantive process and either; (1) an output or (2) an organized workforce with skills critical to the ability to create outputs and inputs that can be utilized to create the outputs. Companies will no longer be required to evaluate whether a market participant could replace any missing inputs or processes, instead focusing on the substance of what was acquired. The provisions of the new standard are effective, on a prospective basis, beginning January 1, 2018, for annual and interim reporting periods and may be adopted early for any transactions not yet reported in issued financial statements. We elected to early adopt the new standard for any new transactions occurring on or after January 1, 2017.

In July 2015, the FASB issued an accounting standards update to simplify the measurement of inventory by requiring that inventory be measured at the lower of cost or net realizable value, rather than at the lower of cost or market, with market being defined as either replacement cost, net realizable value or net realizable value less a normal profit margin. We adopted this guidance as of January 1, 2017. This guidance did not have a significant impact on our condensed consolidated financial statements.

Recently Issued Accounting Standards

In March 2017, the FASB issued an accounting standards update to simplify and improve the reporting of net periodic pension benefit cost by requiring only present service cost to be presented in the same line item as other current

employee compensation costs while remaining components of net periodic benefit cost would be presented within Other (income)/deductions—net outside of operations. We plan to adopt this guidance as of January 1, 2018, the required effective date, and do not expect the new standard will have a significant impact on our consolidated financial statements.

In October 2016, the FASB issued an accounting standards update that will require the recognition of the income tax consequences of an intra-entity asset transfer, other than inventory, when the transfer occurs as opposed to when the asset is sold to an outside third party. The provisions of the new standard are effective beginning January 1, 2018, for annual and interim reporting periods. Early adoption is permitted beginning on January 1, 2017. We plan to adopt this guidance as of January 1, 2018, the required effective date, and do not expect the new standard will have a significant impact on our consolidated financial statements.

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In February 2016, the FASB issued an accounting standards update which requires lessees to recognize most leases on the balance sheet with a corresponding right of use asset. Leases will be classified as financing or operating which will drive the expense recognition pattern. For lessees, the income statement presentation and expense recognition pattern for financing and operating leases is similar to the current model for capital and operating leases, respectively. Companies may elect to exclude short-term leases. The update also requires additional disclosures that will better enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. We plan to adopt this guidance as of January 1, 2019, the required effective date, for annual and interim reporting periods. The new standard requires a modified retrospective adoption approach, at the beginning of the earliest comparative period presented in the financial statements. We continue to assess the potential impact that adopting this new guidance will have on our consolidated financial statements.

In May 2014, the FASB issued an accounting standards update that outlines a new, single comprehensive model for companies to use in accounting for revenue arising from contracts with customers. This update supersedes most current revenue recognition guidance under U.S. GAAP. The core principle of the new guidance is that an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance includes a five-step model for determining how, when and how much revenue should be recognized. This update also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. We plan to adopt this guidance as of January 1, 2018, the required effective date, using the modified retrospective transition method. Under the modified retrospective method, the cumulative effect of applying the new standard will be recognized as of the date of initial application with disclosure of results under both the new and prior standards. We continue to assess the impact of the new standard on our current policies, procedures, and disclosures related to revenue recognition. Based on the work performed to date, we do not believe that the adoption will have a material impact on our consolidated financial statements. While implementation procedures are still ongoing, we have evaluated the impact on our primary revenue stream, product sales, in both the United States and our key international markets and no matters have currently been identified individually or in the aggregate that would have a material impact on the timing or amount of revenue recognition based on the provisions of the new standard.

4. Acquisitions and Divestitures

Assets and Liabilities Held for Sale

On March 30, 2017, as part of our supply network strategy, we announced an agreement with the Brazilian-based pharmaceutical company União Química (UQ) to sell our manufacturing site in Guarulhos, Brazil, and we met the criteria for held for sale classification. The agreement also includes entering into a five-year manufacturing and supply agreement with UQ to begin upon closing of the transaction.

As of July 2, 2017, recorded assets and liabilities held for sale are summarized below:

(MILLIONS OF DOLLARS)	July 2, 2017
Assets held for sale	
Inventories	$ 12
Property, plant and equipment	26
Deferred tax assets	4
Other current assets	8
Goodwill	3
Total	$ 53
Liabilities associated with assets held for sale	
Accounts payable	$ 3
Other current liabilities	1
Total	$ 4

We expect to complete this transaction during the second half of 2017.

Divestitures

On May 11, 2017, we completed the sale of our manufacturing site in Shenzhou, China. We had previously exited operations at this site during the second quarter of 2015 as part of our operational efficiency program. We received total cash proceeds of approximately $3 million and recorded a net pre-tax gain of approximately $2 million within Other (income)/deductions—net. Additionally, in the second quarter of 2017, we recorded a $4 million expense within Other (income)/deductions—net related to the prior year sale of the U.S. manufacturing sites noted below.

On April 28, 2016, we completed the sale of our 55 percent ownership share of a Taiwan joint venture, including a manufacturing site in Hsinchu, Taiwan to Yung Shin Pharmaceutical Industrial Co., Ltd., a pharmaceutical company with an animal health business and headquarters in Taiwan. The sale also included a portfolio of products in conjunction with our comprehensive operational efficiency program. These products include medicated feed additives, anti-infective medicines and nutritional premixes for livestock, sold primarily in Taiwan and in international markets. We received $13 million in cash upon closing.

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On February 17, 2016, we completed the sale of our manufacturing site in Haridwar, India to the India-based pharmaceutical company Zydus Cadila (Cadila Healthcare Ltd.). The agreement also included the sale of a portfolio of our products in conjunction with our comprehensive operational efficiency program.

On February 12, 2016, we completed the sale of two of our manufacturing sites in the United States: Laurinburg, North Carolina, and Longmont, Colorado, to Huvepharma NV (Huvepharma), a European animal health company. Huvepharma also assumed the assets and operations and the lease of our manufacturing and distribution site in Van Buren, Arkansas. The agreement included the sale of a portfolio of products in conjunction with our comprehensive operational efficiency program.

During the first six months of 2016, we received total cash proceeds of approximately $88 million related to the divestitures of the India and U.S. manufacturing sites noted above. During the first quarter of 2016, we recognized a net pre-tax gain of approximately $33 million, partially offset by a net pre-tax loss of approximately $6 million recognized during the second quarter of 2016. Gains and losses related to divestitures are recorded within Other (income)/deductions—net.

5. Restructuring Charges and Other Costs Associated with Acquisitions and Cost-Reduction/Productivity Initiatives

In connection with our cost-reduction/productivity initiatives, we typically incur costs and charges associated with site closings and other facility rationalization actions, workforce reductions and the expansion of shared services, including the development of global systems. In connection with our acquisition activity, we typically incur costs and charges associated with executing the transactions, integrating the acquired operations, which may include expenditures for consulting and the integration of systems and processes, product transfers and restructuring. This may include charges related to employees, assets and activities that will not continue. All operating functions can be impacted by these actions, including sales and marketing, manufacturing and research and development (R&D), as well as functions such as business technology, shared services and corporate operations.

The components of costs incurred in connection with restructuring initiatives, acquisitions and cost-reduction/productivity initiatives are as follows:

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Restructuring charges/(reversals) and certain acquisition-related costs:				
Integration costs[a]	$2	$2	$2	$2
Restructuring charges/(reversals)[b]:				
Employee termination costs	(3)	(24)	(4)	(23)
Exit costs	1	1	1	2
Total Restructuring charges/(reversals) and certain acquisition-related costs	$—	$(21)	$(1)	$(19)

(a) Integration costs represent external, incremental costs directly related to integrating acquired businesses and primarily include expenditures for consulting and the integration of systems and processes, as well as product transfer costs.

(b) The restructuring charges/(reversals) for the three months ended July 2, 2017, are associated with the following: U.S. ($1 million reversal), International ($1 million) and Manufacturing/research/corporate ($2 million reversal). The restructuring charges/(reversals) for the six months ended July 2, 2017, are associated with the following: International ($1 million reversal) and Manufacturing/research/corporate ($2 million reversal).

The restructuring charges/(reversals) for the three months ended July 3, 2016, are associated with the following: U.S. ($1 million reversal), International ($14 million reversal) and Manufacturing/research/corporate ($8 million reversal). The restructuring charges/(reversals) for the six months ended July 3, 2016, are associated with the following: U.S. ($2 million reversal), International ($15 million reversal) and Manufacturing/research/corporate ($4 million reversal).

During 2015, we launched a comprehensive operational efficiency program, which was incremental to the previously announced supply network strategy. These initiatives have focused on reducing complexity in our product portfolios

through the elimination of approximately 5,000 product stock keeping units (SKUs), changing our selling approach in certain markets, reducing our presence in certain countries, and planning to sell or exit 10 manufacturing sites over a long term period. As of July 2, 2017, we divested or exited three U.S. manufacturing sites, three international manufacturing sites, and our 55 percent ownership share of a Taiwan joint venture, inclusive of its related manufacturing site. We are also continuing to optimize our resource allocation and efficiency by reducing resources associated with non-customer facing activities and operating more efficiently as a result of less internal complexity and more standardization of processes. As part of these initiatives, we planned to reduce certain positions through divestitures, normal attrition and involuntary terminations by approximately 2,000 to 2,500, subject to consultations with works councils and unions in certain countries. In 2016, the operations of the Guarulhos, Brazil manufacturing site, including approximately 300 employees, were transferred to us from Pfizer, which increased our range of planned reduction in certain positions to 2,300 to 2,800. Including divestitures, as of July 2, 2017, approximately 2,200 positions have been eliminated and the comprehensive operational efficiency program is substantially complete. We expect additional reductions through divestitures related to our supply network strategy over the next several years.

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Charges related to the operational efficiency initiative and supply network strategy are as follows:

(MILLIONS OF DOLLARS)	Three Months Ended July 2, 2017	Three Months Ended July 3, 2016	Six Months Ended July 2, 2017	Six Months Ended July 3, 2016
Restructuring charges/(reversals) and certain acquisition-related costs:				
Operational efficiency initiative				
Employee termination costs[a]	$2	$(30)	$1	$(29)
Exit costs	1	2	1	3
	3	(28)	2	(26)
Supply network strategy:				
Employee termination costs	(5)	6	(5)	6
	(5)	6	(5)	6
Total restructuring charges/(reversals) related to the operational efficiency initiative and supply network strategy	(2)	(22)	(3)	(20)
Other operational efficiency initiative charges				
Selling, general and administrative expenses:				
Accelerated depreciation	—	1	—	1
Consulting fees	1	4	1	7
Other (income)/deductions—net:				
Net loss/(gain) on sale of assets[b]	2	6	2	(27)
Total other operational efficiency initiative charges	3	11	3	(19)
Other supply network strategy charges				
Cost of sales:				
Accelerated depreciation	1	1	2	2
Consulting fees	—	1	2	3
Total other supply network strategy charges	1	2	4	5
Total charges associated with the operational efficiency initiative and supply network strategy	$2	$(9)	$4	$(34)

(a) For the three and six months ended July 3, 2016, includes a reduction in employee termination accruals primarily as a result of higher than expected voluntary attrition rates experienced in the first half of 2016.

(b) For the three months ended July 3, 2016, primarily represents the net loss on the sale of our share of our Taiwan joint venture as part of our operational efficiency initiative. For the six months ended July 3, 2016, represents the net gain on the sale of certain manufacturing sites and products, partially offset by the loss on the sale of our share of our Taiwan joint venture, as part of our operational efficiency initiative.

The components of, and changes in, our restructuring accruals are as follows:

(MILLIONS OF DOLLARS)	Employee Termination Costs	Exit Costs	Accrual[a]
Balance, December 31, 2016[a]	$ 90	$ —	$ 90
Provision	(4)	1	(3)
Utilization and other[b]	(36)	(1)	(37)
Balance, July 2, 2017[a]	$ 50	$ —	$ 50

(a)

At July 2, 2017, and December 31, 2016, included in Accrued expenses ($29 million and $61 million, respectively) and Other noncurrent liabilities ($21 million and $29 million, respectively).

(b) Includes adjustments for foreign currency translation.

6. Other (Income)/Deductions—Net

The components of Other (income)/deductions—net are as follows:

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Royalty-related income	$(5)	$ (5)	$(12)	$(12)
Net loss/(gain) on sale of assets[a]	2	6	2	(27)
Certain legal and other matters, net[b]	(4)	—	(4)	—
Foreign currency loss[c]	8	8	10	17
Other, net[d]	(3)	(5)	(8)	(4)
Other (income)/deductions—net	$(2)	$ 4	$(12)	$(26)

(a) For the three and six months ended July 2, 2017, represents the net loss related to sales of certain manufacturing sites and products as part of our operational efficiency initiative.

For the three months ended July 3, 2016, primarily represents the net loss on the sale of our share of our Taiwan joint venture as part of our operational efficiency initiative. For the six months ended July 3, 2016, represents the net gain on the sale of certain manufacturing sites and products, partially offset by the loss on the sale of our share of our Taiwan joint venture, as part of our operational efficiency initiative.

(b) For the three and six months ended July 2, 2017, represents income associated with an insurance recovery related to commercial settlements in Mexico recorded in 2014 and 2016.

(c) Primarily driven by costs related to hedging and exposures to certain emerging market currencies.

(d) Includes interest income and other miscellaneous income. For the six months ended July 2, 2017, also includes a settlement refund and reimbursement of legal fees related to costs incurred by Pharmaq prior to the acquisition in 2015. For the three and six months ended July 3, 2016, also includes income associated with certain state business employment tax incentive credits.

7. Income Taxes

A. Taxes on Income

The effective tax rate was 28.4% for the three months ended July 2, 2017, compared with 32.5% for the three months ended July 3, 2016. The lower effective tax rate for the three months ended July 2, 2017, was primarily attributable to:

- changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings from operations and repatriation costs. The jurisdictional mix of earnings can vary as a result of repatriation decisions and operating fluctuations in the normal course of business and the impact of non-deductible items;
- a $2 million discrete tax benefit related to the excess tax benefits for share-based payments recognized as a component of Provision for taxes on income; and
- a $3 million net discrete tax expense recorded in the second quarter of 2016, related to changes in uncertain tax positions due to the impact of the European Commission’s negative decision on the excess profits rulings in Belgium, partially offset by a revaluation of the company's deferred tax assets and liabilities using the Belgium tax rates expected to be in place going forward as a result of the decision.

The effective tax rate was 28.7% for the six months ended July 2, 2017, compared with 35.5% for the six months ended July 3, 2016. The lower effective tax rate for the six months ended July 2, 2017, was primarily attributable to:

- a $38 million net discrete tax expense recorded in the first half of 2016, related to changes in uncertain tax positions due to the impact of the European Commission’s negative decision on the excess profits rulings in Belgium, partially offset by a revaluation of the company's deferred tax assets and liabilities using the Belgium tax rates expected to be in place going forward as a result of the decision;
- changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings from operations and repatriation costs. The jurisdictional mix of earnings can vary as a result of repatriation decisions and operating fluctuations in the normal course of business and the impact of non-deductible items;
-

- a $7 million and $5 million discrete tax benefit recorded in the first half of 2017 and 2016, respectively, related to the excess tax benefits for share-based payments recognized as a component of Provision for taxes on income; and
- a $3 million and $10 million discrete tax benefit recorded in the first quarter of 2017 and 2016, respectively, related to a revaluation of deferred taxes as a result of a change in statutory tax rates.

B. Deferred Taxes

As of July 2, 2017, the total net deferred income tax liability of $168 million is included in Deferred tax assets ($93 million) and Deferred tax liabilities ($261 million).

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As of December 31, 2016, the total net deferred income tax liability of $148 million is included in Deferred tax assets ($96 million) and Deferred tax liabilities ($244 million).

C. Tax Contingencies

As of July 2, 2017, the tax liabilities associated with uncertain tax positions of $75 million (exclusive of interest and penalties related to uncertain tax positions of $11 million) are included in Deferred tax assets ($4 million) and Other taxes payable ($71 million).

As of December 31, 2016, the tax liabilities associated with uncertain tax positions of $68 million (exclusive of interest and penalties related to uncertain tax positions of $10 million) are included in Deferred tax assets ($3 million) and Other taxes payable ($65 million).

Our tax liabilities for uncertain tax positions relate primarily to issues common among multinational corporations. Any settlements or statute of limitations expirations could result in a significant decrease in our uncertain tax positions. Substantially all of these unrecognized tax benefits, if recognized, would impact our effective income tax rate. We do not expect that within the next twelve months any of our uncertain tax positions could significantly decrease as a result of settlements with taxing authorities or the expiration of the statutes of limitations. Our assessments are based on estimates and assumptions that have been deemed reasonable by management, but our estimates of uncertain tax positions and potential tax benefits may not be representative of actual outcomes, and any variation from such estimates could materially affect our financial statements in the period of settlement or when the statutes of limitations expire, as we treat these events as discrete items in the period of resolution. Finalizing audits with the relevant taxing authorities can include formal administrative and legal proceedings, and, as a result, it is difficult to estimate the timing and range of possible changes related to our uncertain tax positions, and such changes could be significant.

8. Financial Instruments

A. Debt

Credit Facilities

In December 2016, we entered into an amended and restated revolving credit agreement with a syndicate of banks providing for a five-year $1.0 billion senior unsecured revolving credit facility (the credit facility), which expires in December 2021. Subject to certain conditions, we have the right to increase the credit facility to up to $1.5 billion. The credit facility contains a financial covenant requiring us to not exceed a maximum total leverage ratio (the ratio of consolidated net debt as of the end of the period to consolidated Earnings Before Interest, Income Taxes, Depreciation and Amortization (EBITDA) for such period) of 3.50:1. Upon entering into a material acquisition, the maximum total leverage ratio increases to 4.00:1, and extends until the fourth full consecutive fiscal quarter ended immediately following the consummation of a material acquisition. The credit facility also contains a clause which adds back to Adjusted Consolidated EBITDA, any operational efficiency restructuring charge (defined as charges recorded by the company during the period commencing on October 1, 2016 and ending December 31, 2019, related to operational efficiency initiatives), provided that for any twelve-month period such charges added back to Adjusted Consolidated EBITDA shall not to exceed $100 million in the aggregate.

The credit facility also contains a financial covenant requiring that we maintain a minimum interest coverage ratio (the ratio of EBITDA at the end of the period to interest expense for such period) of 3.50:1. In addition, the credit facility contains other customary covenants.

We were in compliance with all financial covenants as of July 2, 2017, and December 31, 2016. There were no amounts drawn under the credit facility as of July 2, 2017, or December 31, 2016.

We have additional lines of credit and other credit arrangements with a group of banks and other financial intermediaries for general corporate purposes. We maintain cash and cash equivalent balances in excess of our outstanding short-term borrowings. As of July 2, 2017, we had access to $75 million of lines of credit which expire at various times throughout 2017 and 2018 and are generally renewed annually. We did not have any borrowings outstanding related to these facilities as of July 2, 2017, and December 31, 2016.

Commercial Paper Program and Other Short-Term Borrowings

In February 2013, we entered into a commercial paper program with a capacity of up to $1.0 billion. As of July 2, 2017, there was $100 million of commercial paper borrowings outstanding, with a weighted average interest rate of

1.4%. As of December 31, 2016, there was no commercial paper issued under this program. As of July 2, 2017, and December 31, 2016, we did not have any other short-term borrowings outstanding.

Senior Notes and Other Long-Term Debt

On November 13, 2015, we issued $1.25 billion aggregate principal amount of our senior notes (2015 senior notes), with an original issue discount of $2 million. On January 28, 2013, we issued $3.65 billion aggregate principal amount of our senior notes (the 2013 senior notes offering) in a private placement, with an original issue discount of $10 million.

The current portion of long-term debt was $750 million as of July 2, 2017, with a weighted-average interest rate of 1.875%. There was no current portion of long-term debt as of December 31, 2016.

The 2013 and 2015 senior notes are governed by an indenture and supplemental indenture (collectively, the indenture) between us and Deutsche Bank Trust Company Americas, as trustee. The indenture contains certain covenants, including limitations on our, and certain of our subsidiaries' ability to incur liens or engage in sale-leaseback transactions. The indenture also contains restrictions on our ability to consolidate, merge or sell substantially all of our assets. In addition, the indenture contains other customary terms, including certain events of default, upon the occurrence of which the 2013 and 2015 senior notes may be declared immediately due and payable.

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Pursuant to the indenture, we are able to redeem the 2013 and 2015 senior notes, in whole or in part, at any time by paying a “make whole” premium, plus accrued and unpaid interest to, but excluding, the date of redemption. Pursuant to our tax matters agreement with Pfizer, we will not be permitted to redeem the 2013 senior notes due 2023 pursuant to this optional redemption provision, except under limited circumstances. Upon the occurrence of a change of control of us and a downgrade of the 2013 and 2015 senior notes below an investment grade rating by each of Moody's Investors Service, Inc. and Standard & Poor's Ratings Services, we are, in certain circumstances, required to make an offer to repurchase all of the outstanding 2013 and 2015 senior notes at a price equal to 101% of the aggregate principal amount of the 2013 and 2015 senior notes together with accrued and unpaid interest to, but excluding, the date of repurchase.

The components of our long-term debt are as follows:

(MILLIONS OF DOLLARS)	July 2, 2017	December 31, 2016
1.875% 2013 senior notes due 2018	$750	$ 750
3.450% 2015 senior notes due 2020	500	500
3.250% 2013 senior notes due 2023	1,350	1,350
4.500% 2015 senior notes due 2025	750	750
4.700% 2013 senior notes due 2043	1,150	1,150
	4,500	4,500
Unamortized debt discount / debt issuance costs	(31)	(32)
Less current portion of long-term debt	(750)	—
Long-term debt, net of discount and issuance costs	$3,719	$ 4,468

The fair value of our long-term debt, including the current portion of long-term debt, was $4,773 million and $4,565 million as of July 2, 2017, and December 31, 2016, respectively, and has been determined using a third-party matrix-pricing model that uses significant inputs derived from, or corroborated by, observable market data and Zoetis’ credit rating (Level 2 inputs).

The principal amount of long-term debt outstanding, as of July 2, 2017, matures in the following years:

(MILLIONS OF DOLLARS)	2018	2019	2020	2021	After 2021	Total
Maturities	$750	$ —	$500	$ —	$3,250	$4,500

Interest Expense

Interest expense, net of capitalized interest, was $41 million and $82 million for the three and six months ended July 2, 2017, respectively, and $41 million and $84 million for the three and six months ended July 3, 2016, respectively. Capitalized interest was $1 million and $2 million for each of the three and six months ended July 2, 2017, and July 3, 2016, respectively.

B. Derivative Financial Instruments

Foreign Exchange Risk

A significant portion of our revenue, earnings and net investment in foreign affiliates is exposed to changes in foreign exchange rates. We seek to manage our foreign exchange risk, in part, through operational means, including managing same-currency revenue in relation to same-currency costs and same-currency assets in relation to same-currency liabilities. Depending on market conditions, foreign exchange risk is also managed through the use of derivative financial instruments. These financial instruments serve to protect net income against the impact of the translation into U.S. dollars of certain foreign exchange-denominated transactions. The aggregate notional amount of foreign exchange derivative financial instruments offsetting foreign currency exposures was $1.1 billion and $1.2 billion, as of July 2, 2017, and December 31, 2016, respectively. The derivative financial instruments primarily offset exposures in the Australian dollar, Brazilian real, Canadian dollar, Chinese yuan, euro, and Japanese yen. The vast majority of the foreign exchange derivative financial instruments mature within 60 days and all mature within 180 days.

All derivative contracts used to manage foreign currency risk are measured at fair value and are reported as assets or liabilities on the condensed consolidated balance sheet. The company has not designated the foreign currency

forward-exchange contracts as hedging instruments. We recognize the gains and losses on forward-exchange contracts that are used to offset the same foreign currency assets or liabilities immediately into earnings along with the earnings impact of the items they generally offset. These contracts essentially take the opposite currency position of that reflected in the month-end balance sheet to counterbalance the effect of any currency movement.

Interest Rate Risk

The company may use interest rate swap contracts on certain investing and borrowing transactions to manage its net exposure to interest rates and to reduce its overall cost of borrowing. In anticipation of issuing fixed-rate debt, we may use forward-starting interest rate swaps that are designated as cash flow hedges to hedge against changes in interest rates that could impact expected future issuances of debt. To the extent these hedges of cash flows related to anticipated debt are effective, any unrealized gains or losses on the forward-starting interest rate swaps are reported in Accumulated other comprehensive loss and are recognized in income over the life of the future fixed-rate notes. When the company discontinues hedge accounting because it is no longer probable that an anticipated transaction will occur within the originally

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expected period of execution, or within an additional two-month period thereafter, changes to fair value accumulated in other comprehensive income are recognized immediately in earnings.

For the six months ended July 2, 2017, we entered into interest rate swaps with an aggregate notional value of $200 million, having a term of 10 years and an effective date and mandatory termination date in December 2017. In 2016, we entered into interest rate swaps with an aggregate notional value of $250 million, having a term of 10 years and an effective date and mandatory termination date in December 2017. We designated these swaps as cash flow hedges against interest rate exposure related principally to the anticipated future issuance of fixed-rate debt to be used primarily to refinance our 1.875% 2013 senior note due in 2018. In addition, in previous years we had entered into various forward-starting interest rate swap contracts that were designated as cash flow hedges and that were terminated upon issuance of fixed-rate notes. The deferred gains or losses related to the settlement of these contracts are reclassified from Accumulated other comprehensive loss into income over the period during which the hedged transactions affects earnings.

Fair Value of Derivative Instruments

The classification and fair values of derivative instruments are as follows:

		Fair Value of Derivatives	
(MILLIONS OF DOLLARS)	Balance Sheet Location	July 2, 2017	December 31, 2016
Derivatives Not Designated as Hedging Instruments			
Foreign currency forward-exchange contracts	Other current assets	$6	$ 12
Foreign currency forward-exchange contracts	Other current liabilities	(8)	(8)
Total derivatives not designated as hedging instruments		(2)	4
Derivatives Designated as Hedging Instruments:			
Interest rate swap contracts	Other current assets	14	17
Total derivatives designated as hedging instruments		14	17
Total derivatives		$12	$ 21

We use a market approach in valuing financial instruments on a recurring basis. Our derivative financial instruments are measured at fair value on a recurring basis using Level 2 inputs in the calculation of fair value.

The amounts of net gains/(losses) on derivative instruments not designated as hedging instruments, recorded in Other (income)/deductions—net, are as follows:

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Foreign currency forward-exchange contracts	$7	$(13)	$(22)	$(12)

These amounts were substantially offset in Other (income)/deductions—net by the effect of changing exchange rates on the underlying foreign currency exposures.

The amounts of unrecognized net losses on derivative instruments designated as cash flow hedges, recorded, net of tax, in Other comprehensive income/(loss), are as follows:

	Three Months Ended		Six Months Ended	
	July 2,	July 3,	July 2,	July 3,

(MILLIONS OF DOLLARS)	2017	2016	2017	2016
Interest rate swaps	$(1)	$ (3)	$(1)	$ (3)

The net amount of deferred gains/(losses) that is expected to be reclassified from Accumulated other comprehensive loss into earnings over the next 12 months is insignificant.

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9. Inventories

The components of inventory are as follows:

(MILLIONS OF DOLLARS)	July 2, 2017	December 31, 2016
Finished goods	$784	$ 799
Work-in-process	534	499
Raw materials and supplies	180	204
Inventories	$1,498	$ 1,502

10. Goodwill and Other Intangible Assets

A. Goodwill

The components of, and changes in, the carrying amount of goodwill are as follows:

(MILLIONS OF DOLLARS)	U.S.	International	Total
Balance, December 31, 2016	$661	$ 820	$1,481
Additions[(a)]	5	5	10
Other[(b)]	—	4	4
Balance, July 2, 2017	$666	$ 829	$1,495

(a) Represents the consolidation of a European livestock monitoring company, a variable interest entity of which Zoetis is the primary beneficiary.

(b) Includes adjustments for foreign currency translation, partially offset by the reclassification of $3 million to Assets Held for Sale relating to our manufacturing site in Guarulhos, Brazil. For additional information, see Note 4. Acquisitions and Divestitures: Assets Held for Sale.

The gross goodwill balance was $2,031 million and $2,017 million as of July 2, 2017, and December 31, 2016, respectively. Accumulated goodwill impairment losses were $536 million as of July 2, 2017, and December 31, 2016.

B. Other Intangible Assets

The components of identifiable intangible assets are as follows:

	As of July 2, 2017			As of December 31, 2016		
(MILLIONS OF DOLLARS)	Gross Carrying Amount	Accumulated Amortization	Identifiable Intangible Assets Less Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization	Identifiable Intangible Assets Less Accumulated Amortization
Finite-lived intangible assets:						
Developed technology rights[(a)(b)]	$1,167	$ (385)	$ 782	$1,064	$ (342)	$ 722
Brands	213	(138)	75	213	(132)	81
Trademarks and trade names	62	(46)	16	62	(44)	18
Other	225	(137)	88	222	(130)	92
Total finite-lived intangible assets	1,667	(706)	961	1,561	(648)	913
Indefinite-lived intangible assets:						
Brands	37	—	37	37	—	37
Trademarks and trade names	67	—	67	66	—	66
In-process research and development[(b)]	137	—	137	204	—	204
Product rights	8	—	8	8	—	8
Total indefinite-lived intangible assets	249	—	249	315	—	315
Identifiable intangible assets	$1,916	$ (706)	$ 1,210	$1,876	$ (648)	$ 1,228

(a) Includes the consolidation of a European livestock monitoring company, a variable interest entity of which Zoetis is the primary beneficiary, and intangible assets associated with the purchase of a Norwegian fish vaccination company, both during the first quarter of 2017.

(b) In the first quarter of 2017, certain intangible assets, acquired in 2015 as part of the Pharmaq acquisition, were placed into service.

C. Amortization

Amortization expense related to finite-lived acquired intangible assets that contribute to our ability to sell, manufacture, research, market and distribute products, compounds and intellectual property is included in Amortization of intangible assets as it benefits multiple business functions. Amortization expense related to finite-lived acquired intangible assets that are associated with a single function is included in Cost of sales, Selling, general and administrative expenses or Research and development expenses, as appropriate. Total amortization expense for finite-lived intangible assets was $24 million and $49 million for the three and six months ended July 2, 2017, respectively, and $24 million and $48 million for the three and six months ended July 3, 2016, respectively.

11. Benefit Plans

Our employees ceased to participate in the Pfizer, Inc. U.S. qualified defined benefit plans and the U.S. retiree medical plan effective December 31, 2012, and liabilities associated with our employees under these plans were retained by Pfizer. Pfizer is continuing to credit certain employees' service with Zoetis generally through December 31, 2017 (or termination of employment from Zoetis, if earlier) for certain early retirement benefits with respect to Pfizer's U.S. defined benefit pension and retiree medical plans. Pension and postretirement benefit expense associated with the extended service for certain employees in the U.S. plans totaled approximately $1 million for each of the three month periods ended July 2, 2017, and July 3, 2016, and $3 million for each of the six month periods ended July 2, 2017, and July 3, 2016.

The following table provides the net periodic benefit cost associated with our international defined benefit pension plans:

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Service cost	$ 1	$ 2	$ 3	$ 4
Interest cost	—	1	1	2
Expected return on plan assets	—	—	(1)	(1)
Amortization of net actuarial loss	1	—	1	—
Curtailment and settlement (gain)/loss	—	(1)	1	(1)
Net periodic benefit cost	$ 2	$ 2	$ 5	$ 4

Total company contributions to the international pension plans were $1 million and $4 million for the three and six months ended July 2, 2017, respectively, and $3 million and $6 million for the three and six months ended July 3, 2016, respectively. We expect to contribute a total of approximately $7 million to these plans in 2017.

12. Share-Based Payments

The company may grant a variety of share-based payments under the Zoetis 2013 Equity and Incentive Plan (the Equity Plan) to our employees and non-employee directors. The principal types of share-based awards available under the Equity Plan may include, but are not limited to, stock options, restricted stock and restricted stock units (RSUs), deferred stock units (DSUs), performance-vesting restricted stock units (PSUs) and other equity-based or cash-based awards.

The components of share-based compensation expense are as follows:

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Stock options / stock appreciation rights	$ 2	$ 3	$ 5	$ 5
RSUs / DSUs	7	6	13	12
PSUs	2	1	4	2

Share-based compensation expense—total[a][b]	$11	$ 10	$22	$ 19

[a] For the three and six months ended July 2, 2017, and July 3, 2016, amounts capitalized to inventory were insignificant.

[b] For the three and six months ended July 2, 2017, and three months ended July 3, 2016, the additional share-based compensation expense as a result of accelerated vesting of the outstanding stock options and the settlement, on a pro-rata basis, of other equity awards of terminated employees in connection with our operational efficiency initiative and supply network strategy, which is included in Restructuring charges/(reversals) and certain acquisition-related costs, were insignificant. For the six months ended July 3, 2016, additional share-based compensation expense was approximately $1 million.

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During the six months ended July 2, 2017, the company granted 712,112 stock options with a weighted-average exercise price of $55.09 per stock option and a weighted-average fair value of $14.30 per stock option. The fair-value based method for valuing each Zoetis stock option grant on the grant date uses the Black-Scholes-Merton option-pricing model, which incorporates a number of valuation assumptions. The weighted-average fair value was estimated based on the following assumptions: risk-free interest rate of 2.3%; expected dividend yield of 0.76%; expected stock price volatility of 23.28%; and expected term of 6.5 years. In general, stock options vest after three years of continuous service and the values determined through this fair-value based method generally are amortized on a straight-line basis over the vesting term into Cost of sales, Selling, general and administrative expenses, or Research and development expenses, as appropriate.

During the six months ended July 2, 2017, the company granted 529,932 RSUs with a weighted-average grant date fair value of $55.04 per RSU. RSUs are accounted for using a fair-value-based method that utilizes the closing price of Zoetis common stock on the date of grant. In general, RSUs vest after three years of continuous service from the grant date and the values generally are amortized on a straight-line basis over the vesting term into Cost of sales, Selling, general and administrative expenses, or Research and development expenses, as appropriate.

During the six months ended July 2, 2017, the company granted 136,964 PSUs with a weighted-average grant date fair value of $74.28 per PSU. PSUs are accounted for using a Monte Carlo simulation model. The units underlying the PSUs will be earned and vested over a three-year performance period, based upon the total shareholder return of the company in comparison to the total shareholder return of the companies comprising the S&P 500 index at the start of the performance period (Relative TSR). The weighted-average fair value was estimated based on volatility assumptions of Zoetis common stock and an average of the S&P 500 companies, which were 23.1% and 25.5%, respectively. Depending on the company’s Relative TSR performance at the end of the performance period, the recipient may earn between 0% and 200% of the target number of units. Vested units are settled in shares of the company’s common stock. PSU values are amortized on a straight-line basis over the vesting term into Cost of sales, Selling, general and administrative expenses, or Research and development expenses, as appropriate.

13. Stockholders' Equity

Zoetis is authorized to issue 6 billion shares of common stock and 1 billion shares of preferred stock.

In November 2014, the company's Board of Directors authorized a $500 million share repurchase program. This program was substantially completed as of December 31, 2016. In December 2016, the company's Board of Directors authorized an additional $1.5 billion share repurchase program. Purchases of Zoetis shares may be made at the discretion of management, depending on market conditions and business needs. As of July 2, 2017, there was approximately $1.3 billion remaining under these authorizations.

Changes in common shares and treasury stock were as follows:

(MILLIONS)	Common Shares Issued[a]	Treasury Stock[a]
Balance, December 31, 2015	501.81	4.41
Share-based compensation[b]	0.08	(1.29)
Share repurchase program	—	3.38
Balance, July 3, 2016	501.89	6.50
Balance, December 31, 2016	501.89	9.04
Share-based compensation[b]	—	(1.25)
Share repurchase program	—	4.45
Balance, July 2, 2017	501.89	12.23

(a) Shares may not add due to rounding.

(b) Includes the issuance of shares of common stock and the reissuance of shares from treasury stock in connection with the vesting of employee share-based awards. Treasury stock also includes the reacquisition of shares associated with the vesting of employee share-based awards to satisfy tax withholding requirements. For additional information regarding share-based compensation, see Note 12. Share-Based Payments.

Changes, net of tax, in accumulated other comprehensive loss, excluding noncontrolling interest, are as follows:

(MILLIONS OF DOLLARS)	Derivatives Net Unrealized Gains/(Losses)	Currency Translation Adjustment Net Unrealized Gains/(Losses)	Benefit Plans Actuarial Gains/(Losses)	Accumulated Other Comprehensive Loss
Balance, December 31, 2015	$ (2)	$ (604)	$ (16)	$ (622)
Other comprehensive (loss)/income, net of tax	(3)	66	3	66
Divestiture of noncontrolling interest[a]	—	2	—	2
Balance, July 3, 2016	$ (5)	$ (536)	$ (13)	$ (554)
Balance, December 31, 2016	$ 8	$ (583)	$ (23)	$ (598)
Other comprehensive income, net of tax	(1)	56	1	56
Balance, July 2, 2017	$ 7	$ (527)	$ (22)	$ (542)

[a] Reflects the divestiture of our share of our Taiwan joint venture. See Note 4. Acquisitions and Divestitures: Divestitures.

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14. Earnings per Share

The following table presents the calculation of basic and diluted earnings per share:

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS AND SHARES, EXCEPT PER SHARE DATA)	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Numerator				
Net income before allocation to noncontrolling interests	$247	$224	$486	$428
Less: net income attributable to noncontrolling interests	—	—	1	—
Net income attributable to Zoetis Inc.	$247	$224	$485	$428
Denominator				
Weighted-average common shares outstanding	490.8	496.3	491.6	496.9
Common stock equivalents: stock options, RSUs, PSUs and DSUs	3.2	2.5	3.0	2.3
Weighted-average common and potential dilutive shares outstanding	494.0	498.8	494.6	499.2
Earnings per share attributable to Zoetis Inc. stockholders—basic	$0.50	$0.45	$0.99	$0.86
Earnings per share attributable to Zoetis Inc. stockholders—diluted	$0.50	$0.45	$0.98	$0.86

There were approximately 1 million stock options outstanding for each of the three and six months ended July 2, 2017, and approximately 2 million stock options outstanding for each of the three and six months ended July 3, 2016, under the company's Equity Plan that were excluded from the computation of diluted earnings per share as the effect would have been anti-dilutive.

15. Commitments and Contingencies

We and certain of our subsidiaries are subject to numerous contingencies arising in the ordinary course of business. For a discussion of our tax contingencies, see Note 7. Income Taxes.

A. Legal Proceedings

Our non-tax contingencies include, among others, the following:

- Product liability and other product-related litigation, which can include injury, consumer, off-label promotion, antitrust and breach of contract claims.
- Commercial and other matters, which can include product-pricing claims and environmental claims and proceedings.
- Patent litigation, which typically involves challenges to the coverage and/or validity of our patents or those of third parties on various products or processes.
- Government investigations, which can involve regulation by national, state and local government agencies in the United States and in other countries.

Certain of these contingencies could result in losses, including damages, fines and/or civil penalties, and/or criminal charges, which could be substantial.

We believe that we have strong defenses in these types of matters, but litigation is inherently unpredictable and excessive verdicts do occur. We do not believe that any of these matters will have a material adverse effect on our financial position. However, we could incur judgments, enter into settlements or revise our expectations regarding the outcome of certain matters, and such developments could have a material adverse effect on our results of operations or cash flows in the period in which the amounts are paid.

We have accrued for losses that are both probable and reasonably estimable. Substantially all of these contingencies are subject to significant uncertainties and, therefore, determining the likelihood of a loss and/or the measurement of any loss can be complex. Consequently, we are unable to estimate the range of reasonably possible loss in excess of amounts accrued. Our assessments are based on estimates and assumptions that have been deemed reasonable by management, but the assessment process relies on estimates and assumptions that may prove to be incomplete or inaccurate, and unanticipated events and circumstances may occur that might cause us to change those estimates and assumptions.

Amounts recorded for legal and environmental contingencies can result from a complex series of judgments about future events and uncertainties and can rely on estimates and assumptions.

The principal matters to which we are a party are discussed below. In determining whether a pending matter is significant for financial reporting and disclosure purposes, we consider both quantitative and qualitative factors in order to assess materiality, such as, among other things, the amount of damages and the nature of any other relief sought in the proceeding, if such damages and other relief are specified; our view of the merits of the claims and of the strength of our defenses; whether the action purports to be a class action and our view of the likelihood that a class will be certified by the court; the jurisdiction in which the proceeding is pending; any experience that we or, to our

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knowledge, other companies have had in similar proceedings; whether disclosure of the action would be important to a reader of our financial statements, including whether disclosure might change a reader's judgment about our financial statements in light of all of the information about the company that is available to the reader; the potential impact of the proceeding on our reputation; and the extent of public interest in the matter. In addition, with respect to patent matters, we consider, among other things, the financial significance of the product protected by the patent.

PregSure®

We have approximately 264 claims in Europe and New Zealand seeking damages related to calves claimed to have died of Bovine Neonatal Pancytopenia (BNP) on farms where PregSure BVD, a vaccine against Bovine Virus Diarrhea (BVD), was used. BNP is a rare syndrome that first emerged in cattle in Europe in 2006. Studies of BNP suggest a potential association between the administration of PregSure and the development of BNP, although no causal connection has been established. The cause of BNP is not known.

In 2010, we voluntarily stopped sales of PregSure BVD in Europe, and recalled the product at wholesalers while investigations into possible causes of BNP continued. In 2011, after incidences of BNP were reported in New Zealand, we voluntarily withdrew the marketing authorization for PregSure throughout the world.

We have settled approximately 168 of these claims for amounts that are not material individually or in the aggregate. Investigations into possible causes of BNP continue and these settlements may not be representative of any future claims resolutions.

Ulianopolis, Brazil

In February 2012, the Municipality of Ulianopolis (State of Para, Brazil) filed a complaint against Fort Dodge Saúde Animal Ltda. (FDSAL), a Zoetis entity, and five other large companies alleging that waste sent to a local waste incineration facility for destruction, but that was not ultimately destroyed as the facility lost its operating permit, caused environmental impacts requiring cleanup.

The Municipality is seeking recovery of cleanup costs purportedly related to FDSAL's share of all waste accumulated at the incineration facility awaiting destruction, and compensatory damages to be allocated among the six defendants. We believe we have strong arguments against the claim, including defense strategies against any claim of joint and several liability.

At the request of the Municipal prosecutor, in April 2012, the lawsuit was suspended for one year. Since that time, the prosecutor has initiated investigations into the Municipality's actions in the matter as well as the efforts undertaken by the six defendants to remove and dispose of their individual waste from the incineration facility. On October 3, 2014, the Municipal prosecutor announced that the investigation remained ongoing and outlined the terms of a proposed Term of Reference (a document that establishes the minimum elements to be addressed in the preparation of an Environmental Impact Assessment), under which the companies would be liable to withdraw the waste and remediate the area. On March 5, 2015, we presented our response to the prosecutor's proposed Term of Reference, arguing that the proposed terms were overly general in nature and expressing our interest in discussing alternatives to address the matter. The prosecutor agreed to consider our request to engage a technical consultant to conduct an environmental diagnostic of the contaminated area. On May 29, 2015, we, in conjunction with the other defendant companies, submitted a draft cooperation agreement to the prosecutor, which outlined the proposed terms and conditions for the engagement of a technical consultant to conduct the environmental diagnostic. On August 19, 2016, the parties entered into a cooperation agreement with the prosecutor, pursuant to which a third-party consultant will conduct a limited environmental assessment of the site. We currently await the results of the technical assessment.

Lascadoil Contamination in Animal Feed

An investigation by the U.S. Food and Drug Administration (FDA) and the Michigan Department of Agriculture is ongoing to determine how lascadoil, oil for industrial use, made its way into the feed supply of certain turkey and hog feed mills in Michigan. The contaminated feed is believed to have caused the deaths of approximately 50,000 turkeys and the contamination (but not death) of at least 20,000 hogs in August 2014. While it remains an open question as to how the lascadoil made its way into the animal feed, the allegations are that lascadoil intended to be sold for reuse as biofuel was inadvertently sold to producers of soy oil, who in turn, unknowingly sold the contaminated soy oil to fat recycling vendors, who then sold the contaminated soy oil to feed mills for use in animal feed. Indeed, related to the FDA investigation, Shur-Green Farms LLC, a producer of soy oil, recalled certain batches of soy oil allegedly

contaminated with lascadoil on October 13, 2014.

During the course of its investigation, the FDA identified the process used to manufacture Zoetis' Avatec® (lasalocid sodium) and Bovatec® (lasalocid sodium) products as one possible source of the lascadoil, since lascadoil contains small amounts of lasalocid, the active ingredient found in both products. Zoetis has historically sold any and all industrial lascadoil byproduct to an environmental company specializing in waste disposal. The environmental company is contractually obligated to incinerate the lascadoil or resell it for use in biofuel. Under the terms of the agreement, the environmental company is expressly prohibited from reselling the lascadoil to be used as a component in food. The FDA inspected the Zoetis site where Avatec and Bovatec are manufactured, and found no evidence that Zoetis was involved in the contamination of the animal feed.

On March 10, 2015, plaintiffs Restaurant Recycling, LLC (Restaurant Recycling) and Superior Feed Ingredients, LLC (Superior), both of whom are in the fat recycling business, filed a complaint in the Seventeenth Circuit Court for the State of Michigan against Shur-Green Farms alleging negligence and breach of warranty claims arising from their purchase of soy oil allegedly contaminated with lascadoil. Plaintiffs resold the allegedly contaminated soy oil to turkey feed mills for use in feed ingredient. Plaintiffs also named Zoetis as a defendant in the complaint alleging that Zoetis failed to properly manufacture its products and breached an implied warranty that the soy oil was fit for use at turkey and hog mills. Zoetis was served with the complaint on June 3, 2015, and we filed our answer, denying all allegations, on July 15, 2015. On August 10, 2015, several of the turkey feed mills filed a joint complaint against Restaurant Recycling, Superior, Shur-Green Farms and others, alleging claims for negligence, misrepresentation, and breach of warranty, arising out of their alleged purchase and use of the contaminated soy oil. The complaint raises only one count against Zoetis for negligence. We filed an answer to the complaint on November 2,

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2015, denying the allegation. On May 16, 2016, two additional turkey producers filed a complaint in the Seventeenth Circuit Court for the State of Michigan against the company, Restaurant Recycling, Superior, Shur-Green Farms and others, alleging claims for negligence and breach of warranties. We filed an answer to the complaint on June 20, 2016, denying the allegations. The Court has consolidated all three cases in Michigan for purposes of discovery and disposition. We believe we have strong arguments against all claims.

Other Matters

The European Commission published a decision on alleged competition law infringements by several human health pharmaceutical companies on June 19, 2013. One of the involved legal entities is Alpharma LLC. Alpharma LLC's involvement is solely related to its human health activities prior to Pfizer's acquisition of King/Alpharma. Under the Global Separation Agreement between Pfizer and Zoetis, Pfizer is obligated to indemnify Zoetis for any liabilities arising out of claims not related to its animal health assets. We filed an appeal of the decision on September 6, 2013, to the General Court of the European Union. On September 8, 2016, the General Court upheld the decision of the European Commission. On November 25, 2016, we filed an appeal to the Court of Justice of the European Union and are awaiting a ruling.

B. Guarantees and Indemnifications

In the ordinary course of business and in connection with the sale of assets and businesses, we indemnify our counterparties against certain liabilities that may arise in connection with the transaction or related to activities prior to the transaction. These indemnifications typically pertain to environmental, tax, employee and/or product-related matters and patent-infringement claims. If the indemnified party were to make a successful claim pursuant to the terms of the indemnification, we would be required to reimburse the loss. These indemnifications are generally subject to threshold amounts, specified claim periods and other restrictions and limitations. Historically, we have not paid significant amounts under these provisions and, as of July 2, 2017, recorded amounts for the estimated fair value of these indemnifications were not significant.

16. Segment and Other Revenue Information

A. Segment Information

Operating Segments

We manage our operations through two geographic operating segments: the United States and International. Each operating segment has responsibility for its commercial activities. Within each of these operating segments, we offer a diversified product portfolio, including vaccines, parasiticides, anti-infectives, medicated feed additives and other pharmaceuticals, for both livestock and companion animal customers. Our chief operating decision maker uses the revenue and earnings of the two operating segments, among other factors, for performance evaluation and resource allocation.

Other Costs and Business Activities

Certain costs are not allocated to our operating segment results, such as costs associated with the following:

- Other business activities includes our Client Supply Services (CSS) contract manufacturing results, as well as expenses associated with our dedicated veterinary medicine research and development organization, research alliances, U.S. regulatory affairs and other operations focused on the development of our products. Other R&D-related costs associated with non-U.S. market and regulatory activities are generally included in the international commercial segment.
- Corporate, which is responsible for platform functions such as business technology, facilities, legal, finance, human resources, business development, and communications, among others. These costs also include compensation costs, certain procurement costs, and other miscellaneous operating expenses not charged to our operating segments, as well as interest income and expense.
- Certain transactions and events such as (i) Purchase accounting adjustments, where we incur expenses associated with the amortization of fair value adjustments to inventory, intangible assets and property, plant and equipment; (ii) Acquisition-related activities, where we incur costs associated with acquiring and integrating newly acquired businesses, such as transaction costs and integration costs; and (iii) Certain significant items, which comprise substantive, unusual items that, either as a result of their nature or size, would not be expected to occur as part of our normal business on a regular basis, such as certain costs related to becoming an independent public company,

restructuring charges and implementation costs associated with our cost-reduction/productivity initiatives that are not associated with an acquisition, certain asset impairment charges, certain legal and commercial settlements and the impact of divestiture-related gains and losses.

- Other unallocated includes (i) certain overhead expenses associated with our global manufacturing operations not charged to our operating segments; (ii) certain costs associated with business technology and finance that specifically support our global manufacturing operations; (iii) certain supply chain and global logistics costs; and (iv) certain procurement costs.

Segment Assets

We manage our assets on a total company basis, not by operating segment. Therefore, our chief operating decision maker does not regularly review any asset information by operating segment and, accordingly, we do not report asset information by operating segment. Total assets were approximately $7.8 billion at July 2, 2017, and $7.6 billion at December 31, 2016.

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Selected Statement of Income Information

	Earnings		Depreciation and Amortization[a]	
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Three months ended				
U.S.				
Revenue	$623	$594		
Cost of sales	134	134		
Gross profit	489	460		
Gross margin	78.5 %	77.4 %		
Operating expenses	113	100		
Other (income)/deductions	—	—		
U.S. Earnings	376	360	$ 7	$ 7
International				
Revenue[b]	634	602		
Cost of sales	219	201		
Gross profit	415	401		
Gross margin	65.5 %	66.6 %		
Operating expenses	126	124		
Other (income)/deductions	2	1		
International Earnings	287	276	11	11
Total operating segments	663	636	18	18
Other business activities	(73)	(74)	6	6
Reconciling Items:				
Corporate	(151)	(171)	13	12
Purchase accounting adjustments	(21)	(28)	21	21
Acquisition-related costs	(2)	(2)	—	—
Certain significant items[c]	1	4	—	2
Other unallocated	(72)	(33)	1	1
Total Earnings[d]	$345	$332	$ 59	$ 60

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	Earnings		Depreciation and Amortization[a]	
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Six months ended				
U.S.				
Revenue	$1,228	$1,176		
Cost of sales	271	265		
Gross profit	957	911		
Gross margin	77.9 %	77.5 %		
Operating expenses	209	192		
Other (income)/deductions	—	—		
U.S. Earnings	748	719	$ 14	$ 13
International				
Revenue[b]	1,249	1,169		
Cost of sales	432	397		
Gross profit	817	772		
Gross margin	65.4 %	66.0 %		
Operating expenses	240	233		
Other (income)/deductions	(1)	3		
International Earnings	578	536	22	22
Total operating segments	1,326	1,255	36	35
Other business activities	(147)	(148)	12	12
Reconciling Items:				
Corporate	(294)	(340)	25	22
Purchase accounting adjustments	(43)	(54)	43	43
Acquisition-related costs	(2)	(3)	—	—
Certain significant items[c]	(3)	17	2	3
Other unallocated	(155)	(63)	3	2
Total Earnings[d]	$682	$664	$ 121	$ 117

(a) Certain production facilities are shared. Depreciation and amortization is allocated to the reportable operating segments based on estimates of where the benefits of the related assets are realized.

(b) Revenue denominated in euros was $155 million and $303 million for the three and six months ended July 2, 2017, respectively, and $158 million and $312 million for the three and six months ended July 3, 2016, respectively.

(c) For the three months ended July 2, 2017, Certain significant items primarily includes: (i) a reversal of previously accrued employee termination costs of $3 million, exit costs of $1 million, accelerated depreciation of $1 million, consulting fees of $1 million, and a net loss on sales of certain manufacturing sites and products of $2 million related to our operational efficiency initiative and supply network strategy, (ii) charges of $1 million associated with changes to our operating model, and (iii) income of $4 million related to an insurance recovery from commercial settlements in Mexico recorded in 2014 and 2016.

For the three months ended July 3, 2016, Certain significant items primarily includes: (i) Zoetis stand-up costs of $5 million; (ii) a net loss of $6 million related to sales of certain manufacturing sites and products as a result of our operational efficiency initiative; (iii) a $24 million net reduction in certain employee termination accruals, partially offset by exit costs of $1 million, accelerated depreciation of $2 million, and consulting fees of $5 million, related to our operational efficiency initiative, supply network strategy, and other restructuring activities, and (iv) charges of $1

million associated with changes to our operating model. Stand-up costs include certain nonrecurring costs related to becoming an independent public company, such as the creation of standalone systems and infrastructure, site separation, new branding (including changes to the manufacturing process for required new packaging), and certain legal registration and patent assignment costs.

For the six months ended July 2, 2017, Certain significant items primarily includes: (i) a reversal of previously accrued employee termination costs of $4 million, exit costs of $1 million, accelerated depreciation charges of $2 million, consulting fees of $3 million, and a net loss related to sales of certain manufacturing sites and products of $2 million, related to our operational efficiency initiative and supply network strategy, (ii) charges of $3 million associated with changes to our operating model, and (iii) income of $4 million related to an insurance recovery from commercial settlements in Mexico recorded in 2014 and 2016.

For the six months ended July 3, 2016, Certain significant items primarily includes: (i) Zoetis stand-up costs of $17 million; (ii) a net gain of $27 million related to sales of certain manufacturing sites and products as a result of our operational efficiency initiative, (iii) a $23 million net reduction in certain employee termination accruals, partially offset by exit costs of $2 million, accelerated depreciation of $3 million and consulting fees of $10 million related to our operational efficiency initiative, supply network strategy and other restructuring activities, and (iv) charges of $1 million associated with changes to our operating model.

(d) Defined as income before provision for taxes on income.

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B. Other Revenue Information

Revenue by Species

Species revenue are as follows:

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Livestock:				
Cattle	$382	$366	$768	$743
Swine	148	150	308	296
Poultry	122	118	238	240
Fish	19	22	40	39
Other	18	17	38	38
	689	673	1,392	1,356
Companion Animal:				
Horses	35	36	70	75
Dogs and Cats	533	487	1,015	914
	568	523	1,085	989
Contract Manufacturing	12	12	23	25
Total revenue	$1,269	$1,208	$2,500	$2,370

Revenue by Major Product Category

Revenue by major product category are as follows:

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Anti-infectives	$278	$272	$546	$563
Vaccines	324	310	643	611
Parasiticides	206	189	390	334
Medicated feed additives	121	128	244	266
Other pharmaceuticals	282	248	554	469
Other non-pharmaceuticals	46	49	100	102
Contract manufacturing	12	12	23	25
Total revenue	$1,269	$1,208	$2,500	$2,370

Review Report of Independent Registered Public Accounting Firm

The Shareholders and Board of Directors

Zoetis Inc.:

We have reviewed the accompanying condensed consolidated balance sheet of Zoetis Inc. and subsidiaries (the Company) as of July 2, 2017, and the related condensed consolidated statements of income and comprehensive income for the three and six-month periods ended July 2, 2017, and July 3, 2016, and the related condensed consolidated statements of equity and cash flows for the six-month periods ended July 2, 2017 and July 3, 2016. These condensed consolidated financial statements are the responsibility of the Company's management.

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We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the condensed consolidated financial statements as of July 2, 2017, and for the three and six-month periods ended July 2, 2017, and July 3, 2016, referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Zoetis Inc. and subsidiaries as of December 31, 2016, and the related consolidated statements of income, comprehensive income, equity, and cash flows for the year then ended (not presented herein); and in our report dated February 16, 2017, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2016, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ KPMG LLP
Short Hills, New Jersey
August 8, 2017

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

Overview of our business

We are a global leader in the discovery, development, manufacture and commercialization of animal health medicines and vaccines, with a focus on both livestock and companion animals. For more than 60 years we have been committed to enhancing the health of animals and bringing solutions to our customers who raise and care for them.

We manage our operations through two geographic operating segments: the United States (U.S.) and International. Within each of these operating segments, we offer a diversified product portfolio for both livestock and companion animal customers in order to capitalize on local and regional trends and customer needs. See Notes to Condensed Consolidated Financial Statements— Note 16. Segment and Other Revenue Information.

We directly market our products to veterinarians and livestock producers located in approximately 45 countries across North America, Europe, Africa, Asia, Australia and South America, and are a market leader in nearly all of the major regions in which we operate. Through our efforts to establish an early and direct presence in many emerging markets, such as Brazil, China and Mexico, we believe we are the largest animal health medicines and vaccines business as measured by revenue across emerging markets as a whole. In markets where we do not have a direct commercial presence, we generally contract with distributors that provide logistics and sales and marketing support for our products.

We believe our investments in the industry's largest sales organization, including our extensive network of technical and veterinary operations specialists, our high-quality manufacturing and reliability of supply, and our long track record of developing products that meet customer needs, has led to enduring and valued relationships with our customers. Our research and development (R&D) efforts enable us to deliver innovative products to address unmet needs and evolve our product lines so they remain relevant for our customers. Additionally, our management team's focus on improving operational and cost efficiencies increases the likelihood of achieving our core growth strategies and enhancing long-term value for our shareholders.

A summary of our 2017 performance compared with the comparable 2016 period follows:

	Three Months Ended			Six Months Ended		
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	% Change	July 2, 2017	July 3, 2016	% Change
Revenue	$1,269	$1,208	5	$2,500	$2,370	5
Net income attributable to Zoetis	247	224	10	485	428	13
Adjusted net income[(a)]	261	246	6	522	485	8

(a) Adjusted net income is a non-GAAP financial measure. See the "Adjusted net income" section of this Management's Discussion and Analysis (MD&A) for more information.

Our operating environment

For a description of our operating environment, including factors which could materially affect our business, financial condition, or future results, see "Our Operating Environment" in the MD&A of our 2016 Annual Report on Form 10-K. Set forth below are updates to certain of the factors disclosed in our 2016 Form 10-K.

Quarterly Variability of Financial Results

Our quarterly financial results are subject to variability related to a number of factors including but not limited to: weather patterns, herd management decisions, economic conditions, regulatory actions, competitive dynamics, disease outbreaks, product and geographic mix, timing of price increases and timing of investment decisions.

Disease outbreaks

Sales of our livestock products could be adversely affected by the outbreak of disease carried by animals. Outbreaks of disease may reduce regional or global sales of particular animal-derived food products or result in reduced exports of such products, either due to heightened export restrictions or import prohibitions, which may reduce demand for our products. Also, the outbreak of any highly contagious disease near our main production sites could require us to immediately halt production of our products at such sites or force us to incur substantial expenses in procuring raw materials or products elsewhere. Alternatively, sales of products that treat specific disease outbreaks may increase.

For example, outbreaks of highly pathogenic H5 avian flu affected (infected or exposed) 48 million birds in the United States in 2014 and 2015, and significantly impacted the egg and turkey industry. In March 2016, we were granted a conditional license from the United States Department of Agriculture (USDA) for a vaccine to help prevent avian influenza, and in June 2016, we were awarded a contract to supply the USDA with this vaccine for the National Veterinary Stockpile. The vaccine is intended for use in chickens as an aid in the prevention of disease caused by the H5N1 subtype of the virus. The USDA will determine if a vaccination program should be implemented. It is important to note that human infection with avian influenza viruses has not occurred from eating properly cooked poultry or poultry products. We are closely monitoring the developments as this situation unfolds and currently believe the impact on our 2017 global revenue will not be significant.

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Foreign exchange rates

Significant portions of our revenue and costs are exposed to changes in foreign exchange rates. Our products are sold in more than 100 countries and, as a result, our revenue is influenced by changes in foreign exchange rates. For the six months ended July 2, 2017, approximately 47% of our revenue was denominated in foreign currencies. We seek to manage our foreign exchange risk, in part, through operational means, including managing same-currency revenue in relation to same-currency costs and same-currency assets in relation to same-currency liabilities. As we operate in multiple foreign currencies, including the Australian dollar, Brazilian real, Canadian dollar, euro, U.K. pound and other currencies, changes in those currencies relative to the U.S. dollar will impact our revenue, cost of goods and expenses, and consequently, net income. Exchange rate fluctuations may also have an impact beyond our reported financial results and directly impact operations. These fluctuations may affect the ability to buy and sell our goods and services between markets impacted by significant exchange rate variances. For the six months ended July 2, 2017, approximately 53% of our total revenue was in U.S. dollars. Our year-over-year revenue growth was unfavorably impacted by 1% from changes in foreign currency values relative to the U.S. dollar.

Analysis of the condensed consolidated statements of income

The following discussion and analysis of our statements of income should be read along with our condensed consolidated financial statements and the notes thereto included elsewhere in Part I— Item 1 of this Quarterly Report on Form 10-Q.

	Three Months Ended			Six Months Ended		
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	% Change	July 2, 2017	July 3, 2016	% Change
Revenue	$1,269	$1,208	5	$2,500	$2,370	5
Costs and expenses:						
Cost of sales[(a)]	440	399	10	883	788	12
% of revenue	35 %	33 %		35 %	33 %	
Selling, general and administrative expenses[(a)]	336	343	(2)	645	658	(2)
% of revenue	26 %	28 %		26 %	28 %	
Research and development expenses[(a)]	86	88	(2)	176	178	(1)
% of revenue	7 %	7 %		7 %	8 %	
Amortization of intangible assets[(a)]	23	22	5	45	43	5
Restructuring charges/(reversals) and certain acquisition-related costs	—	(21)	(100)	(1)	(19)	(95)
Interest expense, net of capitalized interest	41	41	—	82	84	(2)
Other (income)/deductions—net	(2)	4	*	(12)	(26)	(54)
Income before provision for taxes on income	345	332	4	682	664	3
% of revenue	27 %	27 %		27 %	28 %	
Provision for taxes on income	98	108	(9)	196	236	(17)
Effective tax rate	28.4 %	32.5 %		28.7 %	35.5 %	
Net income before allocation to noncontrolling interests	247	224	10	486	428	14
Less: Net income attributable to noncontrolling interests	—	—	—	1	—	—
Net income attributable to Zoetis	$247	$224	10	$485	$428	13
% of revenue	19 %	19 %		19 %	18 %	

* Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

(a) Amortization expense related to finite-lived acquired intangible assets that contribute to our ability to sell, manufacture, research, market and distribute products, compounds and intellectual property is included in Amortization of intangible assets as these intangible assets benefit multiple business functions. Amortization expense related to finite-lived acquired intangible assets that are associated with a single function is included in Cost of sales, Selling, general and administrative expenses or Research and development expenses, as appropriate.

Revenue

Three months ended July 2, 2017 vs. three months ended July 3, 2016

Total revenue increased by $61 million, or 5%, in the three months ended July 2, 2017, compared with the three months ended July 3, 2016, reflecting higher operational revenue of $68 million, or 6%. Operational revenue growth was comprised primarily of the following:

- increased sales of our dermatology portfolio and new product launches, which contributed approximately 6%; and
- growth of our in-line products, which contributed approximately 1%, due to increased volume,

partially offset by:

- our product rationalizations as part of the operational efficiency initiative, which resulted in a decline of approximately 1%.

Foreign exchange reduced our reported revenue growth by $7 million.

Six months ended July 2, 2017 vs. six months ended July 3, 2016

Total revenue increased by $130 million, or 5%, in the six months ended July 2, 2017, compared with the six months ended July 3, 2016, reflecting higher operational revenue of $141 million, or 6%. Operational revenue growth was comprised primarily of the following:

- increased sales of our dermatology portfolio and new product launches, which contributed approximately 6%; and
- growth of our in-line products, which contributed approximately 1%, due to price increases,

partially offset by:

- our product rationalizations as part of the operational efficiency initiative, which resulted in a decline of approximately 1%.

Foreign exchange reduced our reported revenue growth by $11 million.

Costs and Expenses

Cost of sales

	Three Months Ended			Six Months Ended		
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	% Change	July 2, 2017	July 3, 2016	% Change
Cost of sales	$440	$399	10	$883	$788	12
% of revenue	34.7 %	33.0 %		35.3 %	33.2 %	

Certain amounts and percentages may reflect rounding adjustments.

Three months ended July 2, 2017 vs. three months ended July 3, 2016

Cost of sales increased by $41 million, or 10%, in the three months ended July 2, 2017, compared with the three months ended July 3, 2016, primarily as a result of:

- the timing of the recognition of certain manufacturing and supply costs (while we expect these costs to be elevated in the first half of the year, we anticipate improvement in cost of sales as a percentage of revenue in the second half, compared with 2016);
- an increase in sales volume;
- unfavorable foreign exchange; and
- an increase in inventory obsolescence, scrap and other charges,

partially offset by:

- the nonrecurrence of charges reflecting fair value adjustments to inventory related to the acquisition of Pharmaq.

Six months ended July 2, 2017 vs. six months ended July 3, 2016

Cost of sales increased by $95 million, or 12%, in the six months ended July 2, 2017, compared with the six months ended July 3, 2016, primarily as a result of:

- the timing of the recognition of certain manufacturing and supply costs (while we expect these costs to be elevated in the first half of the year, we anticipate improvement in cost of sales as a percentage of revenue in the second half, compared with 2016);
- an increase in sales volume;
- unfavorable foreign exchange; and
- an increase in inventory obsolescence, scrap and other charges,

partially offset by:

- the nonrecurrence of charges reflecting fair value adjustments to inventory related to the acquisition of Pharmaq.

Selling, general and administrative expenses

	Three Months Ended			Six Months Ended		
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	% Change	July 2, 2017	July 3, 2016	% Change
Selling, general and administrative expenses	$336	$343	(2)	$645	$658	(2)
% of revenue	26%	28%		26%	28%	

Certain amounts and percentages may reflect rounding adjustments.

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Three months ended July 2, 2017 vs. three months ended July 3, 2016

Selling, general & administrative (SG&A) expenses decreased by $7 million, or 2%, in the three months ended July 2, 2017, compared with the three months ended July 3, 2016, primarily as a result of:

- a decline in certain compensation-related expenses;
- lower bad debt expense; and
- a reduction in the amount of additional costs related to becoming an independent public company,

partially offset by:

- higher advertising and promotional spending associated with new products and Apoquel®.

Six months ended July 2, 2017 vs. six months ended July 3, 2016

Selling, general & administrative (SG&A) expenses decreased by $13 million, or 2%, in the six months ended July 2, 2017, compared with the six months ended July 3, 2016, primarily as a result of:

- a reduction in the amount of additional costs related to becoming an independent public company;
- a decline in certain compensation-related expenses;
- a reduction in the general and administrative expenses driven by our operational efficiency initiative;
- lower bad debt expense; and
- favorable foreign exchange,

partially offset by:

- higher advertising and promotional spending associated with new products and Apoquel®.

Research and development expenses

	Three Months Ended			Six Months Ended		
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	% Change	July 2, 2017	July 3, 2016	% Change
Research and development expenses	$86	$88	(2)	$176	$178	(1)
% of revenue	7%	7%		7%	8%	

Certain amounts and percentages may reflect rounding adjustments.

Three months ended July 2, 2017 vs. three months ended July 3, 2016

R&D expenses decreased by $2 million, or 2%, in the three months ended July 2, 2017, compared with the three months ended July 3, 2016, primarily as a result of:

- a reduction in research and development expenses driven by our operational efficiency initiative; and
- certain compensation-related expenses,

partially offset by:

- the inclusion of the veterinary diagnostics business acquired in 2016; and
- timing of laboratory supply purchases.

Six months ended July 2, 2017 vs. six months ended July 3, 2016

R&D expenses decreased by $2 million, or 1%, in the six months ended July 2, 2017, compared with the six months ended July 3, 2016, primarily as a result of:

- a reduction in research and development expenses driven by our operational efficiency initiative,

partially offset by:

- the inclusion of the veterinary diagnostics business acquired in 2016; and
- increased variable expenses due to project spending.

Amortization of intangible assets

	Three Months Ended			Six Months Ended		
	July 2,	July 3,	%	July 2,	July 3,	%

(MILLIONS OF DOLLARS)	20172016	Change	20172016	Change
Amortization of intangible assets	$23 $ 22	5	$45 $ 43	5

Certain amounts and percentages may reflect rounding adjustments.

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Three months ended July 2, 2017 vs. three months ended July 3, 2016

Amortization of intangible assets increased by $1 million, or 5%, in the three months ended July 2, 2017, compared with the three months ended July 3, 2016, primarily as a result of certain intangible assets, acquired in 2015 as part of the Pharmaq acquisition, being placed into service during the first quarter of 2017.

Six months ended July 2, 2017 vs. six months ended July 3, 2016

Amortization of intangible assets increased by $2 million, or 5%, in the six months ended July 2, 2017, compared with the six months ended July 3, 2016, primarily as a result of certain intangible assets, acquired in 2015 as part of the Pharmaq acquisition, being placed into service during the first quarter of 2017.

Restructuring charges/(reversals) and certain acquisition-related costs

	Three Months Ended			Six Months Ended		
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	% Change	July 2, 2017	July 3, 2016	% Change
Restructuring charges/(reversals) and certain acquisition-related costs	$—	$(21)	(100)	$(1)	$(19)	(95)

Certain amounts and percentages may reflect rounding adjustments.

During 2015, we launched a comprehensive operational efficiency program, which is incremental to the previously announced supply network strategy. These initiatives have focused on reducing complexity in our product portfolios, changing our selling approach in certain markets and reducing our presence in certain countries, and planning to sell or exit ten manufacturing sites over a long term period. We are also continuing to optimize our resource allocation and efficiency by reducing resources associated with non-customer facing activities and operating more efficiently as a result of less internal complexity and more standardization of processes. As part of this initiative, we planned to reduce certain positions through divestitures, normal attrition and involuntary terminations by approximately 2,000 to 2,500, subject to consultations with works councils and unions in certain countries. In 2016, the operations of the Guarulhos, Brazil manufacturing site, including approximately 300 employees, were transferred to us from Pfizer, which increased our range of planned reduction in certain positions to 2,300 to 2,800. Including divestitures, as of July 2, 2017, approximately 2,200 positions have been eliminated and the comprehensive operational efficiency program is substantially complete. We expect additional reductions through divestitures related to our supply network strategy over the next several years.

Our acquisition-related costs primarily relate to restructuring charges for employees, assets and activities that will not continue in the future, as well as integration costs. The majority of our net restructuring charges generally relate to termination costs, but we have also exited a number of distributor and other contracts and performed facility rationalization efforts. Our integration costs are generally comprised of consulting costs related to the integration of systems and processes, as well as product transfer costs.

For additional information regarding restructuring charges and acquisition-related costs, see Notes to Condensed Consolidated Financial Statements— Note 5. Restructuring Charges and Other Costs Associated with Acquisitions and Cost-Reduction/Productivity Initiatives.

Three months ended July 2, 2017 vs. three months ended July 3, 2016

The change in restructuring charges and certain acquisition-related costs from a $21 million reversal in the three months ended July 3, 2016, to $0 million in three months ended July 2, 2017, is primarily a result of our operational efficiency initiative being substantially complete as of the second quarter of 2017, and a net reduction in employee termination accruals in the second quarter of 2016, associated with our operational efficiency initiative, primarily as a result of higher than expected voluntary attrition rates experienced in the first half of 2016.

Six months ended July 2, 2017 vs. six months ended July 3, 2016

The change in restructuring charges and certain acquisition-related costs from a $19 million reversal in the six months ended July 3, 2016, to a $1 million reversal in the six months ended July 2, 2017, is primarily a result of our operational efficiency initiative being substantially complete as of the second quarter of 2017, and a net reduction in employee termination charges in the first half of 2016, associated with our operational efficiency initiative, primarily

as a result of higher than expected voluntary attrition rates experienced in the first half of 2016.

Interest expense, net of capitalized interest

(MILLIONS OF DOLLARS)	Three Months Ended July 2, 2017	July 3, 2016	% Change	Six Months Ended July 2, 2017	July 3, 2016	% Change
Interest expense, net of capitalized interest	$41	$ 41	—	$82	$ 84	(2)

Certain amounts and percentages may reflect rounding adjustments.

Three months ended July 2, 2017 vs. three months ended July 3, 2016

Interest expense, net of capitalized interest, was flat in the three months ended July 2, 2017, compared with the three months ended July 3, 2016.

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Six months ended July 2, 2017 vs. six months ended July 3, 2016

Interest expense, net of capitalized interest, decreased by $2 million, or 2%, in the six months ended July 2, 2017, compared with the six months ended July 3, 2016, as a result of the $400 million of senior notes that matured in the first quarter of 2016.

Other (income)/deductions—net

	Three Months Ended			Six Months Ended		
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	% Change	July 2, 2017	July 3, 2016	% Change
Other (income)/deductions—net	$(2)	$ 4	*	$(12)	$(26)	(54)

*Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

Three months ended July 2, 2017 vs. three months ended July 3, 2016

The change in Other (income)/deductions—net from deductions of $4 million in the three months ended July 3, 2016, to income of $2 million in the three months ended July 2, 2017, is primarily a result of:

- an insurance recovery of $4 million related to commercial settlements in Mexico recorded in 2014 and 2016; and
- a net loss of $2 million for the three months ended July 2, 2017 compared to a net loss of $6 million for the three months ended July 3, 2016, related to divestitures as part of our operational efficiency initiative,

partially offset by:

- lower income associated with certain state business employment tax incentive credits.

Six months ended July 2, 2017 vs. six months ended July 3, 2016

The change in Other (income)/deductions—net from income of $26 million in the six months ended July 3, 2016, to income of $12 million in the six months ended July 2, 2017, is primarily a result of:

- a net gain of $27 million in the first half of 2016 compared to a net loss of $2 million in the first half of 2017, related to divestitures as part of our operational efficiency initiative; and
- lower income associated with certain state business employment tax incentive credits,

partially offset by:

- an insurance recovery of $4 million related to commercial settlements in Mexico in 2014 and 2016;
- lower foreign currency losses, primarily driven by costs related to hedging and exposures to certain emerging market currencies; and
- a settlement refund and reimbursement of legal fees related to costs incurred by Pharmaq prior to the acquisition in 2015.

Provision for taxes on income

	Three Months Ended			Six Months Ended		
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	% Change	July 2, 2017	July 3, 2016	% Change
Provision for taxes on income	$98	$108	(9)	$196	$236	(17)
Effective tax rate	28.4%	32.5 %		28.7 %	35.5 %	

Certain amounts and percentages may reflect rounding adjustments.

Three months ended July 2, 2017 vs. three months ended July 3, 2016

The effective tax rate was 28.4% for the three months ended July 2, 2017, compared with 32.5% for the three months ended July 3, 2016. The lower effective tax rate for the three months ended July 2, 2017, was primarily attributable to:

- changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings from operations and repatriation costs. The jurisdictional mix of earnings can vary as a result of repatriation decisions and operating fluctuations in the normal course of business and the impact of non-deductible items;

- a $2 million discrete tax benefit related to the excess tax benefits for share-based payments recognized as a component of Provision for taxes on income; and
- a $3 million net discrete tax expense recorded in the second quarter of 2016, related to changes in uncertain tax positions due to the impact of the European Commission’s negative decision on the excess profits rulings in Belgium, partially offset by a revaluation of the company's deferred tax assets and liabilities using the Belgium tax rates expected to be in place going forward as a result of the decision.

Six months ended July 2, 2017 vs. six months ended July 3, 2016

The effective tax rate was 28.7% for the six months ended July 2, 2017, compared with 35.5% for the six months ended July 3, 2016. The lower effective tax rate for the six months ended July 2, 2017, was primarily attributable to:

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- a $38 million net discrete tax expense recorded in the first half of 2016, related to changes in uncertain tax positions due to the impact of the European Commission’s negative decision on the excess profits rulings in Belgium, partially offset by a revaluation of the company's deferred tax assets and liabilities using the Belgium tax rates expected to be in place going forward as a result of the decision;
- changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings from operations and repatriation costs. The jurisdictional mix of earnings can vary as a result of repatriation decisions and operating fluctuations in the normal course of business and the impact of non-deductible items;
- a $7 million and $5 million discrete tax benefit recorded in the first half of 2017 and 2016, respectively, related to the excess tax benefits for share-based payments recognized as a component of Provision for taxes on income; and
- a $3 million and $10 million discrete tax benefit recorded in the first quarter of 2017 and 2016, respectively, related to a revaluation of deferred taxes as a result of a change in statutory tax rates.

Operating Segment Results

We believe that it is important to not only understand overall revenue and earnings growth, but also "operational growth." Operational growth is defined as revenue or earnings growth excluding the impact of foreign exchange. On a global basis, the mix of revenue between livestock and companion animal products was as follows:

	Three Months Ended		% Change		
				Related to	
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	Total	Foreign Exchange	Operational
U.S.					
Livestock	$269	$262	3	—	3
Companion animal	354	332	7	—	7
	623	594	5	—	5
International					
Livestock	420	411	2	(1)	3
Companion animal	214	191	12	(3)	15
	634	602	5	(2)	7
Total					
Livestock	689	673	2	(1)	3
Companion animal	568	523	9	(1)	10
Contract manufacturing	12	12	—	3	(3)
	$1,269	$1,208	5	(1)	6

Certain amounts and percentages may reflect rounding adjustments.

	Six Months Ended		% Change		
				Related to	
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	Total	Foreign Exchange	Operational
U.S.					
Livestock	$551	$550	—	—	—
Companion animal	677	626	8	—	8
	1,228	1,176	4	—	4
International					
Livestock	841	806	4	(1)	5
Companion animal	408	363	12	(3)	15
	1,249	1,169	7	(1)	8
Total					
Livestock	1,392	1,356	3	—	3
Companion animal	1,085	989	10	—	10
Contract manufacturing	23	25	(8)	(2)	(6)
	$2,500	$2,370	5	(1)	6

Certain amounts and percentages may reflect rounding adjustments.

Earnings by segment and the operational and foreign exchange changes versus the comparable prior year period were as follows:

	Three Months Ended		% Change		
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	Total	Related to Foreign Exchange	Operational
U.S.					
Revenue	$623	$594	5	—	5
Cost of Sales	134	134	—	—	—
Gross Profit	489	460	6	—	6
Gross Margin	78.5 %	77.4 %			
Operating Expenses	113	100	13	—	13
Other (income)/deductions	—	—	—	—	—
U.S. Earnings	376	360	4	—	4
International					
Revenue	634	602	5	(2)	7
Cost of Sales	219	201	9	1	8
Gross Profit	415	401	3	(3)	6
Gross Margin	65.5 %	66.6 %			
Operating Expenses	126	124	2	(1)	3
Other (income)/deductions	2	1	*	*	*
International Earnings	287	276	4	(3)	7
Total operating segments	663	636	4	(2)	6
Other business activities	(73)	(74)	(1)		
Reconciling Items:					
Corporate	(151)	(171)	(12)		
Purchase accounting adjustments	(21)	(28)	(25)		
Acquisition-related costs	(2)	(2)	—		
Certain significant items	1	4	(75)		
Other unallocated	(72)	(33)	*		
Income before provision for taxes on income	$345	$332	4		

* Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

(MILLIONS OF DOLLARS)	Six Months Ended July 2, 2017	July 3, 2016	% Change Total	Related to Foreign Exchange	Operational
U.S.					
Revenue	$1,228	$1,176	4	—	4
Cost of Sales	271	265	2	—	2
Gross Profit	957	911	5	—	5
Gross Margin	77.9 %	77.5 %			
Operating Expenses	209	192	9	—	9
Other (income)/deductions	—	—	—	—	—
U.S. Earnings	748	719	4	—	4
International					
Revenue	1,249	1,169	7	(1)	8
Cost of Sales	432	397	9	1	8
Gross Profit	817	772	6	(1)	7
Gross Margin	65.4 %	66.0 %			
Operating Expenses	240	233	3	(1)	4
Other (income)/deductions	(1)	3	*	*	*
International Earnings	578	536	8	(2)	10
Total operating segments	1,326	1,255	6	(1)	7
Other business activities	(147)	(148)	(1)		
Reconciling Items:					
Corporate	(294)	(340)	(14)		
Purchase accounting adjustments	(43)	(54)	(20)		
Acquisition-related costs	(2)	(3)	(33)		
Certain significant items	(3)	17	*		
Other unallocated	(155)	(63)	*		
Income before provision for taxes on income	$682	$664	3		

* Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

Three months ended July 2, 2017 vs. three months ended July 3, 2016

U.S. operating segment

U.S. segment revenue increased by $29 million, or 5%, in the three months ended July 2, 2017, compared with the three months ended July 3, 2016, reflecting growth of approximately $7 million in livestock products and growth of approximately $22 million in companion animal products.

- Livestock revenue growth was driven primarily by increased sales of cattle and poultry products. Growth was partially offset by lower sales of swine products due to competition. In addition, certain medicated feed additive products for both cattle and swine were negatively impacted by livestock producers' implementation of the Veterinary Feed Directive, and we expect this trend to continue for the remainder of 2017.
- Companion animal revenue growth was driven by increased sales in our dermatology portfolio, in addition to several other new product launches. Growth was partially offset by lower sales of our pain products due to competition and timing of promotional campaigns.

U.S. segment earnings increased by $16 million, or 4%, in the three months ended July 2, 2017, compared with the three months ended July 3, 2016, primarily due to revenue growth with improved gross margin, partially offset by higher operating expenses related to promotional activity for new products and Apoquel®.

International operating segment

International segment revenue increased by $32 million, or 5%, in the three months ended July 2, 2017, compared with the three months ended July 3, 2016. Operational revenue increased by $40 million, or 7%, driven by growth of approximately $11 million in livestock products and growth of approximately $29 million in companion animal products.

- Livestock growth was driven primarily by increased sales of cattle and swine products. In cattle, growth was due to higher sales in Brazil and other Latin American markets, with increased demand in Brazil as a result of field force expansion, while swine was driven by growth in China. Growth was partially offset by product rationalizations as a result of our operational efficiency initiative.
- Companion animal revenue growth resulted primarily from increased sales of Apoquel®, in addition to new product launches, primarily Simparica®.

Additionally, segment revenue was unfavorably impacted by foreign exchange, which decreased revenue by approximately $8 million, or 2%, primarily driven by the depreciation of the euro and U.K. pound, partially offset by appreciation of the Brazilian real.

International segment earnings increased by $11 million, or 4%, in the three months ended July 2, 2017, compared with the three months ended July 3, 2016. Operational earnings growth was $21 million, or 7%, primarily due to higher revenue, partially offset by a lower gross margin.

Six months ended July 2, 2017 vs. six months ended July 3, 2016

U.S. operating segment

U.S. segment revenue increased by $52 million, or 4%, in the six months ended July 2, 2017, compared with the six months ended July 3, 2016, reflecting growth of approximately $1 million in livestock products and growth of approximately $51 million in companion animal products.

- Livestock revenue increased due to higher sales of poultry and cattle products. Sales of cattle products were partially offset by lower disease risk and incidence in the feedlot sector due to mild weather and heavier animals earlier in the year. Certain medicated feed additive products for both cattle and swine were negatively impacted by livestock producers' implementation of the Veterinary Feed Directive, and we expect this trend to continue for the remainder of 2017.
- Companion animal revenue growth was driven primarily by our dermatology portfolio, in addition to new product launches, particularly Simparica®. Growth was tempered by the prior year's initial sales of other products into expanded distribution relationships, as well as lower sales of our pain products due to competition.

U.S. segment earnings increased by $29 million, or 4%, in the six months ended July 2, 2017, compared with the six months ended July 3, 2016, primarily due to revenue growth and improved gross margins, partially offset by higher operating expenses related to promotional activity for new products and Apoquel®.

International operating segment

International segment revenue increased by $80 million, or 7% in the six months ended July 2, 2017, compared with the six months ended July 3, 2016. Operational revenue increased by $91 million, or 8%, driven by growth of approximately $38 million in livestock products and growth of approximately $53 million in companion animal products.

- Livestock growth was driven primarily by increased sales of swine products in China, new product launches across a variety of markets, and cattle products in Brazil. Growth was partially offset by product rationalizations, primarily impacting poultry and swine product sales.
- Companion animal revenue growth resulted primarily from increased sales of Apoquel®, in addition to new product launches, primarily Simparica®. Sales also benefited from increased demand for our vaccines portfolio in China due to field force expansions and increasing medicalization rates.

Additionally, segment revenue was unfavorably impacted by foreign exchange, which decreased revenue by approximately $11 million, or 1%, primarily driven by the depreciation of the U.K. pound and euro, partially offset by appreciation of the Brazilian real.

International segment earnings increased by $42 million, or 8%, in the six months ended July 2, 2017, compared with the six months ended July 3, 2016. Operational earnings growth was $53 million, or 10%, primarily due to higher revenue, partly offset by a lower gross margin.

Other business activities

Other business activities includes our Client Supply Services (CSS) contract manufacturing results, as well as expenses associated with our dedicated veterinary medicine research and development organization, research alliances, U.S. regulatory affairs and other operations focused on the development of our products. Other R&D-related

costs associated with non-U.S. market and regulatory activities are generally included in the respective regional segment.

Three months ended July 2, 2017 vs. three months ended July 3, 2016

Other business activities net loss decreased by $1 million, or 1%, in the three months ended July 2, 2017, compared with the three months ended July 3, 2016, reflecting higher earnings in our contract manufacturing business.

Six months ended July 2, 2017 vs. six months ended July 3, 2016

Other business activities net loss decreased by $1 million, or 1% in the six months ended July 2, 2017, compared with the six months ended July 3, 2016, reflecting an increase in variable R&D expense driven by higher project spending and the inclusion of the veterinary diagnostics business acquired in 2016, partially offset by a reduction in fixed R&D spending driven by our operational efficiency initiative and higher earnings in our contract manufacturing business.

Reconciling items

Reconciling items include certain costs that are not allocated to our operating segments results, such as costs associated with the following:

- Corporate, which includes certain costs associated with business technology, facilities, legal, finance, human resources, business development and communications, among others. These costs also include certain compensation costs, certain procurement costs, and other miscellaneous operating expenses that are not charged to our operating segments, as well as interest income and expense;
- Certain transactions and events such as (i) Purchase accounting adjustments, which includes expenses associated with the amortization of fair value adjustments to inventory, intangible assets, and property, plant and equipment; (ii) Acquisition-related activities, which includes costs for acquisition and integration; and (iii) Certain significant items, which includes non-acquisition-related restructuring charges, certain asset impairment charges, stand-up costs, certain legal and commercial settlements, and costs associated with cost reduction/productivity initiatives; and
- Other unallocated, which includes (i) certain overhead expenses associated with our global manufacturing operations not charged to our operating segments; (ii) certain costs associated with business technology and finance that specifically support our global manufacturing operations; (iii) certain supply chain and global logistics costs; and (iv) certain procurement costs.

Three months ended July 2, 2017 vs. three months ended July 3, 2016

Corporate expenses decreased by $20 million, or 12%, in the three months ended July 2, 2017, compared with the three months ended July 3, 2016, primarily due to a decrease in certain compensation costs not allocated to our operating segments and the favorable impact of foreign exchange.

Other unallocated expenses increased by $39 million in the three months ended July 2, 2017, compared with the three months ended July 3, 2016, primarily due to the unfavorable impact of foreign exchange, higher global manufacturing and supply costs, and the timing of the recognition of certain manufacturing and supply costs.

Six months ended July 2, 2017 vs. six months ended July 3, 2016

Corporate expenses decreased by $46 million, or 14%, in the six months ended July 2, 2017, compared with the six months ended July 3, 2016, primarily due to the favorable impact of foreign exchange, a decrease in certain compensation costs not allocated to our operating segments and a reduction in general and administrative expense driven by our operational efficiency initiative.

Other unallocated expenses increased by $92 million in the six months ended July 2, 2017, compared with the six months ended July 3, 2016, primarily due to the unfavorable impact of foreign exchange, timing of the recognition of certain manufacturing and supply costs and higher global manufacturing and supply costs.

See Notes to Condensed Consolidated Financial Statements—Note 16. Segment and Other Revenue Information for further information.

Adjusted net income

General description of adjusted net income (a non-GAAP financial measure)

Adjusted net income is an alternative view of performance used by management, and we believe that investors' understanding of our performance is enhanced by disclosing this performance measure. We report adjusted net income to portray the results of our major operations, the discovery, development, manufacture and commercialization of our products, prior to considering certain income statement elements. We have defined adjusted net income as net income attributable to Zoetis before the impact of purchase accounting adjustments, acquisition-related costs and certain significant items described below. The adjusted net income measure is not, and should not be viewed as, a substitute for U.S. GAAP reported net income attributable to Zoetis.

The adjusted net income measure is an important internal measurement for us. We measure our overall performance on this basis in conjunction with other performance metrics. The following are examples of how the adjusted net

income measure is utilized:

- senior management receives a monthly analysis of our operating results that is prepared on an adjusted net income basis;
- our annual budgets are prepared on an adjusted net income basis; and
- other goal setting and performance measurements.

Despite the importance of this measure to management in goal setting and performance measurement, adjusted net income is a non-GAAP financial measure that has no standardized meaning prescribed by U.S. GAAP and, therefore, may not be comparable to the calculation of similar measures of other companies. Adjusted net income is presented to permit investors to more fully understand how management assesses performance.

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We also recognize that, as an internal measure of performance, the adjusted net income measure has limitations, and we do not restrict our performance management process solely to this metric. A limitation of the adjusted net income measure is that it provides a view of our operations without including all events during a period, such as the effects of an acquisition or amortization of purchased intangibles, and does not provide a comparable view of our performance to other companies. We also use other specifically tailored metrics designed to achieve the highest levels of performance.

Purchase accounting adjustments

Adjusted net income is calculated prior to considering certain significant purchase accounting impacts that result from business combinations and net asset acquisitions. These impacts, primarily associated with the acquisition of the Pharmaq business (acquired in November 2015), certain assets of Abbott Animal Health (acquired in February 2015), King Animal Health (KAH) (acquired in 2011), Fort Dodge Animal Health (FDAH) (acquired in 2009), and Pharmacia Animal Health business (acquired in 2003), include amortization related to the increase in fair value of the acquired finite-lived intangible assets and depreciation related to the increase/decrease to fair value of the acquired fixed assets. Therefore, the adjusted net income measure includes the revenue earned upon the sale of the acquired products without considering the aforementioned significant charges.

While certain purchase accounting adjustments can occur through 20 or more years, this presentation provides an alternative view of our performance that is used by management to internally assess business performance. We believe the elimination of amortization attributable to acquired intangible assets provides management and investors an alternative view of our business results by providing a degree of parity to internally developed intangible assets for which R&D costs previously have been expensed.

A completely accurate comparison of internally developed intangible assets and acquired intangible assets cannot be achieved through adjusted net income. These components of adjusted net income are derived solely from the impact of the items listed above. We have not factored in the impact of any other differences in experience that might have occurred if we had discovered and developed those intangible assets on our own, and this approach does not intend to be representative of the results that would have occurred in those circumstances. For example, our R&D costs in total, and in the periods presented, may have been different; our speed to commercialization and resulting revenue, if any, may have been different; or our costs to manufacture may have been different. In addition, our marketing efforts may have been received differently by our customers. As such, in total, there can be no assurance that our adjusted net income amounts would have been the same as presented had we discovered and developed the acquired intangible assets.

Acquisition-related costs

Adjusted net income is calculated prior to considering transaction and integration costs associated with significant business combinations or net asset acquisitions because these costs are unique to each transaction and represent costs that were incurred to acquire and integrate certain businesses as a result of the acquisition decision. We have made no adjustments for the resulting synergies.

We believe that viewing income prior to considering these charges provides investors with a useful additional perspective because the significant costs incurred in a business combination result primarily from the need to eliminate duplicate assets, activities or employees—a natural result of acquiring a fully integrated set of activities. For this reason, we believe that the costs incurred to convert disparate systems, to close duplicative facilities or to eliminate duplicate positions (for example, in the context of a business combination) can be viewed differently from those costs incurred in the ordinary course of business.

The integration costs associated with a business combination may occur over several years, with the more significant impacts generally ending within three years of the transaction. Because of the need for certain external approvals for some actions, the span of time needed to achieve certain restructuring and integration activities can be lengthy. For example, due to the regulated nature of the animal health medicines and vaccines business, the closure of excess facilities can take several years, as all manufacturing changes are subject to extensive validation and testing and must be approved by the FDA and/or other regulatory authorities.

Certain significant items

Adjusted net income is calculated prior to considering certain significant items. Certain significant items represent substantive, unusual items that are evaluated on an individual basis. Such evaluation considers both the quantitative and the qualitative aspect of their unusual nature. Unusual, in this context, may represent items that are not part of our ongoing business; items that, either as a result of their nature or size, we would not expect to occur as part of our normal business on a regular basis; items that would be nonrecurring; or items that relate to products that we no longer sell. While not all-inclusive, examples of items that could be included as certain significant items would be costs related to becoming an independent public company; a major non-acquisition-related restructuring charge and associated implementation costs for a program that is specific in nature with a defined term, such as those related to our non-acquisition-related cost-reduction and productivity initiatives; amounts related to disposals of products or facilities that do not qualify as discontinued operations as defined by U.S. GAAP; certain intangible asset impairments; adjustments related to the resolution of certain tax positions; significant currency devaluation; the impact of adopting certain significant, event-driven tax legislation; or charges related to legal matters. See Notes to Condensed Consolidated Financial Statements—Note 15. Commitments and Contingencies. Our normal, ongoing defense costs or settlements of and accruals on legal matters made in the normal course of our business would not be considered certain significant items.

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Reconciliation

A reconciliation of net income attributable to Zoetis, as reported under U.S. GAAP, to adjusted net income follows:

	Three Months Ended			Six Months Ended		
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	% Change	July 2, 2017	July 3, 2016	% Change
GAAP reported net income attributable to Zoetis	$247	$224	10	$485	$428	13
Purchase accounting adjustments—net of tax	15	18	(17)	34	27	26
Acquisition-related costs—net of tax	1	1	—	1	4	(75)
Certain significant items—net of tax	(2)	3	*	2	26	(92)
Non-GAAP adjusted net income[a]	$261	$246	6	$522	$485	8

*Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

(a) The effective tax rate on adjusted pretax income is 28.9% and 31.3% for the three months ended July 2, 2017 and July 3, 2016, respectively. The lower effective tax rate for the three months ended July 2, 2017, compared with the three months ended July 3, 2016, was primarily attributable to changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings as well as repatriation costs, and a $2 million discrete tax benefit recorded in the second quarter of 2017 related to the excess tax benefits for share-based payments recognized as a component of Provision for taxes on income.

The effective tax rate on adjusted pretax income is 28.4% and 31.1% for the six months ended July 2, 2017, and July 3, 2016, respectively. The lower effective tax rate for the six months ended July 2, 2017, compared with the six months ended July 3, 2016, was primarily attributable to changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings as well as repatriation costs, and a $7 million and $5 million discrete tax benefit recorded in the first half of 2017 and 2016, respectively, related to the excess tax benefits for share-based payments recognized as a component of Provision for taxes on income.

A reconciliation of reported diluted earnings per share (EPS), as reported under U.S. GAAP, to non-GAAP adjusted diluted EPS follows:

	Three Months Ended			Six Months Ended		
Earnings per share—diluted[a]	July 2, 2017	July 3, 2016	% Change	July 2, 2017	July 3, 2016	% Change
GAAP reported EPS attributable to Zoetis—diluted	$0.50	$0.45	11	$0.98	$0.86	14
Purchase accounting adjustments—net of tax	0.03	0.04	(25)	0.07	0.05	40
Acquisition-related costs—net of tax	—	—	—	—	0.01	(100)
Certain significant items—net of tax	—	—	—	0.01	0.05	(80)
Non-GAAP adjusted EPS—diluted	$0.53	$0.49	8	$1.06	$0.97	9

Certain amounts and percentages may reflect rounding adjustments.

(a) Diluted earnings per share was computed using the weighted-average common shares outstanding during the period plus the common stock equivalents related to stock options, RSUs, PSUs and DSUs.

Adjusted net income includes the following charges for each of the periods presented:

	Three Months Ended	Six Months Ended

(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Interest expense, net of capitalized interest	$41	$ 41	$82	$ 84
Interest income	3	2	5	4
Income taxes	106	112	207	219
Depreciation	33	32	67	62
Amortization	5	5	9	9

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Adjusted net income, as shown above, excludes the following items:

(MILLIONS OF DOLLARS)	Three Months Ended July 2, 2017	Three Months Ended July 3, 2016	Six Months Ended July 2, 2017	Six Months Ended July 3, 2016
Purchase accounting adjustments:				
Amortization and depreciation[a]	$20	$20	$40	$39
Cost of sales[b]	1	8	3	15
Total purchase accounting adjustments—pre-tax	21	28	43	54
Income taxes[c]	6	10	9	27
Total purchase accounting adjustments—net of tax	15	18	34	27
Acquisition-related costs:				
Integration costs	2	2	2	2
Other	—	—	—	1
Total acquisition-related costs—pre-tax	2	2	2	3
Income taxes[c]	1	1	1	(1)
Total acquisition-related costs—net of tax	1	1	1	4
Certain significant items:				
Operational efficiency initiative[d]	6	(17)	5	(45)
Supply network strategy[e]	(4)	8	(1)	11
Other restructuring charges and cost-reduction/productivity initiatives	—	(1)	—	(1)
Stand-up costs[f]	—	5	—	17
Other[g]	(3)	1	(1)	1
Total certain significant items—pre-tax	(1)	(4)	3	(17)
Income taxes[c]	1	(7)	1	(43)
Total certain significant items—net of tax	(2)	3	2	26
Total purchase accounting adjustments, acquisition-related costs, and certain significant items—net of tax	$14	$22	$37	$57

Certain amounts may reflect rounding adjustments.

(a) Amortization and depreciation expenses related to Purchase accounting adjustments with respect to identifiable intangible assets and property, plant and equipment.

(b) Amortization and depreciation expense, as well as fair value adjustments to acquired inventory.

(c) Income taxes include the tax effect of the associated pre-tax amounts, calculated by determining the jurisdictional location of the pre-tax amounts and applying that jurisdiction's applicable tax rate.

Income taxes in Purchase accounting adjustments for the three and six months ended July 2, 2017, also includes a tax benefit related to the revaluation of deferred taxes as a result of a change in tax rates and a net tax benefit and charge, respectively, related to prior period tax adjustments. Income taxes in Purchase accounting adjustments for the six months ended July 3, 2016, includes a tax benefit related to the revaluation of deferred taxes as a result of a change in tax rates.

Income taxes in Acquisition-related costs for the six months ended July 3, 2016, also includes a tax charge related to the acquisition of certain assets of Abbott Animal Health.

Income taxes in Certain significant items for the six months ended July 2, 2017, also includes a net charge of approximately $1 million related to the revaluation of the company’s deferred tax assets and liabilities, using the rates expected to be in place at the time of the reversal. Income taxes in Certain significant items for the three and six months ended July 3, 2016, includes a net tax charge of approximately $3 million and $38 million, respectively, related to the impact of the European Commission’s negative decision on the excess profits rulings in Belgium. These

net charges relate to the Belgium government's recovery of prior tax benefits for the periods 2013 through 2015 offset by the revaluation of the company’s deferred tax assets and liabilities using the rates expected to be in place at the time of the reversal. These net charges do not include any benefits associated with a successful appeal of the decision.

(d) For the three months ended July 2, 2017, represents employee termination costs of $2 million, exit costs $1 million, consulting fees of $1 million, and a net loss related to sales of certain manufacturing sites and products of $2 million. For the six months ended July 2, 2017, represents employee termination costs of $1 million, exit costs of $1 million, consulting fees of $1 million, and a net loss related to sales of certain manufacturing sites and products of $2 million.

For the three months ended July 3, 2016, includes a reversal of previously accrued employee termination costs of $30 million, exit costs of $2 million, accelerated depreciation of $1 million, consulting fees of $4 million, and a net loss on sales of certain manufacturing sites and products of $6 million. For the six months ended July 3, 2016, includes a reversal of previously accrued employee termination costs of $29 million, exit costs of $3 million, accelerated depreciation of $1 million, consulting fees of $7 million, and a net gain on sales of certain manufacturing sites and products of $27 million.

(e) For the three months ended July 2, 2017, represents accelerated depreciation of $1 million, and a reversal of previously accrued employee terminations costs of $5 million. For the six months ended July 2, 2017, represents accelerated depreciation of $2 million, consulting fees of $2 million, and a reversal of previously accrued employee terminations costs of $5 million.

For the three and six months ended July 3, 2016, includes restructuring charges of $6 million related to employee termination costs, accelerated depreciation charges of $1 million and $2 million, respectively, and consulting fees of $1 million and $3 million, respectively.

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(f) Certain nonrecurring costs related to becoming an independent public company, such as the creation of standalone systems and infrastructure, site separation, new branding (including changes to the manufacturing process for required new packaging), and certain legal registration and patent assignment costs.

(g) For the three months ended July 2, 2017, represents costs associated with changes to our operating model of $1 million, and income of $4 million related to an insurance recovery from commercial settlements in Mexico recorded in 2014 and 2016. For the six months ended July 2, 2017, represents costs associated with changes to our operating model of $3 million, and income of $4 million related to an insurance recovery from commercial settlements in Mexico recorded in 2014 and 2016. For the three and six months ended July 3, 2016, represents costs associated with changes to our operating model.

The classification of the above items excluded from adjusted net income are as follows:

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Cost of sales:				
Purchase accounting adjustments	$1	$8	$3	$15
Accelerated depreciation	1	1	2	2
Consulting fees	—	1	2	3
Stand-up costs	—	1	—	2
Other	1	—	1	—
Total Cost of sales	3	11	8	22
Selling, general & administrative expenses:				
Purchase accounting adjustments	2	2	3	3
Accelerated depreciation	—	1	—	1
Consulting fees	1	4	1	7
Stand-up costs	—	4	—	15
Other	—	1	2	1
Total Selling, general & administrative expenses	3	12	6	27
Research & development expenses:				
Purchase accounting adjustments	—	—	1	1
Total Research & development expenses	—	—	1	1
Amortization of intangible assets:				
Purchase accounting adjustments	18	18	36	35
Total Amortization of intangible assets	18	18	36	35
Restructuring (reversals)/ charges and certain acquisition-related costs:				
Integration costs	2	2	2	2
Employee termination costs	(3)	(24)	(4)	(23)
Exit costs	1	1	1	2
Total Restructuring (reversals)/ charges and certain acquisition-related costs	—	(21)	(1)	(19)
Other (income)/deductions—net:				
Net loss/(gain) on sale of assets	2	6	2	(27)
Acquisition-related costs	—	—	—	1

Other	(4)	—	(4)	—
Total Other (income)/deductions—net	(2)	6	(2)	(26)
Provision for taxes on income	8	4	11	(17)
Total purchase accounting adjustments, acquisition-related costs, and certain significant items—net of tax	$14	$22	$37	$57

Certain amounts may reflect rounding adjustments.

Analysis of the condensed consolidated statements of comprehensive income

Substantially all changes in other comprehensive income for the periods presented are related to foreign currency translation adjustments. These changes result from the strengthening or weakening of the U.S. dollar as compared to the currencies in the countries in which we do business. The gains and losses associated with these changes are deferred on the balance sheet in Accumulated other comprehensive loss until realized.

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Analysis of the condensed consolidated balance sheets
July 2, 2017 vs. December 31, 2016

For a discussion about the changes in Cash and cash equivalents, Short-term borrowings, Current portion of long-term debt, and Long-term debt, net of discount and issuance costs, see “Analysis of financial condition, liquidity and capital resources” below.

Accounts receivable, less allowance for doubtful accounts increased as a result of the timing of customer collections and the impact of foreign exchange.

Assets held for sale and Liabilities associated with assets held for sale increased as a result of an agreement to sell our manufacturing site in Guarulhos, Brazil. See Notes to Condensed Consolidated Financial Statements— Note 4. Acquisitions and Divestitures: Assets Held for Sale.

Other current assets increased primarily as a result of the timing of U.S. income tax payments as well as other higher prepaid expenses.

Property, plant and equipment, less accumulated depreciation decreased primarily as a result of depreciation expense and a reclassification to Assets Held for Sale as a result of an agreement to sell our manufacturing site in Guarulhos, Brazil, partially offset by capital spending. See Notes to Condensed Consolidated Financial Statements—Note 4. Acquisitions and Divestitures: Assets Held for Sale

Identifiable intangible assets, less accumulated amortization decreased primarily due to amortization expense, partially offset by the impact of foreign exchange, the consolidation of a European livestock monitoring company, a variable interest entity of which Zoetis is the primary beneficiary, and the acquisition of a Norwegian fish vaccination company, both in the first quarter of 2017. See Notes to Condensed Consolidated Financial Statements— Note 10. Goodwill and Other Intangible Assets.

Goodwill increased as a result of the consolidation of a European livestock monitoring company, a variable interest entity of which Zoetis is the primary beneficiary, and the impact of foreign exchange, partially offset by the reclassification to Assets Held for Sale as a result of an agreement to sell our manufacturing site in Guarulhos, Brazil. See Notes to Condensed Consolidated Financial Statements— Note 4. Acquisitions and Divestitures: Assets Held for Sale and Note 10. Goodwill and Other Intangible Assets.

The net changes in Deferred tax assets, Deferred tax liabilities, Income taxes payable and Other taxes payable primarily reflect adjustments to the accrual for the income tax provision for the first half of 2017, as well as the impact of the revaluation of deferred taxes as a result of a change in tax rates. See Notes to Condensed Consolidated Financial Statements— Note 7. Income Taxes.

Accounts payable decreased as a result of the timing of payments.

Accrued compensation and related items decreased primarily due to payment of 2016 annual bonuses to eligible employees and 2016 employee savings plan contributions, partially offset by the pro rata accrual of similar items for 2017.

Accrued expenses and Other current liabilities decreased primarily as a result of payment of accrued expenses, including employee termination costs associated with operational efficiency initiatives. See Notes to Condensed Consolidated Financial Statements— Note 5. Restructuring Charges and Other Costs Associated with Acquisitions and Cost-Reduction/Productivity Initiatives.

For an analysis of the changes in Total Equity, see the Condensed Consolidated Statements of Equity and Notes to Condensed Consolidated Financial Statements— Note 13. Stockholders' Equity.

Analysis of the condensed consolidated statements of cash flows

	Six Months Ended		
(MILLIONS OF DOLLARS)	July 2, 2017	July 3, 2016	% Change
Net cash provided by (used in):			
Operating activities	$299	$188	59
Investing activities	(88)	(31)	*

Financing activities	(240)	(651)	(63)
Effect of exchange-rate changes on cash and cash equivalents	7	(2)	*
Net decrease in cash and cash equivalents	$(22)	$(496)	(96)

* Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

Operating activities

Six months ended July 2, 2017 vs. six months ended July 3, 2016

Net cash provided by operating activities was $299 million for the six months ended July 2, 2017, compared with net cash provided by operating activities of $188 million for the six months ended July 3, 2016. The increase in operating cash flows was primarily attributable to the timing of receipts and payments in the ordinary course of business and higher income before allocation to noncontrolling interests, partially offset by higher U.S. income tax payments.

Investing activities

Six months ended July 2, 2017 vs. six months ended July 3, 2016

Our net cash used in investing activities was $88 million for the six months ended July 2, 2017, compared with net cash used in investing activities of $31 million for the six months ended July 3, 2016. The net cash used in investing activities for 2017 was due primarily to purchases of property, plant and equipment and the acquisition of a Norwegian fish vaccination company. The net cash used in investing activities for 2016 was due primarily to purchases of property, plant and equipment and the acquisition of a livestock business in South America, partially offset by proceeds from the sale of certain manufacturing sites and products as part of the operational efficiency initiative.

Financing activities

Six months ended July 2, 2017 vs. six months ended July 3, 2016

Our net cash used in financing activities was $240 million for the six months ended July 2, 2017, compared with net cash used in financing activities of $651 million for the six months ended July 3, 2016. The net cash used in financing activities for 2017 was due primarily to the purchase of treasury shares and the payment of dividends, partially offset by the issuance of commercial paper. The net cash used in financing activities for 2016 was due primarily to the senior note payment in February 2016, the purchase of treasury shares, the payment of dividends, and the contingent consideration payment to Abbott.

Analysis of financial condition, liquidity and capital resources

While we believe our cash and cash equivalents on hand, our operating cash flows and our existing financing arrangements will be sufficient to support our future cash needs, this may be subject to the environment in which we operate. Risks to our meeting future funding requirements include global economic conditions described in the following paragraph.

Global financial markets may be impacted by macroeconomic, business and financial volatility. As markets change, we will continue to monitor our liquidity position, but there can be no assurance that a challenging economic environment or an economic downturn will not impact our liquidity or our ability to obtain future financing.

Selected measures of liquidity and capital resources

Certain relevant measures of our liquidity and capital resources follow:

(MILLIONS OF DOLLARS)	July 2, 2017	December 31, 2016
Cash and cash equivalents	$ 705	$ 727
Accounts receivable, net[(a)]	975	913
Short-term borrowings	100	—
Current portion of long-term debt	750	—
Long-term debt	3,719	4,468
Working capital	1,800	2,273
Ratio of current assets to current liabilities	2.01:1	3.03:1

(a) Accounts receivable are usually collected over a period of 60 to 90 days. For the six months ended July 2, 2017, compared with December 31, 2016, the number of days that accounts receivables are outstanding remained approximately the same. We regularly monitor our accounts receivable for collectability, particularly in markets where economic conditions remain uncertain. We believe that our allowance for doubtful accounts is appropriate. Our assessment is based on such factors as past due aging, historical and expected collection patterns, the financial condition of our customers, the robust nature of our credit and collection practices and the economic environment.

For additional information about the sources and uses of our funds, see the Analysis of the condensed consolidated balance sheets and Analysis of the condensed consolidated statements of cash flows sections of this MD&A.

Credit facility and other lines of credit

In December 2016, we entered into an amended and restated revolving credit agreement with a syndicate of banks providing for a five-year $1.0 billion senior unsecured revolving credit facility (the credit facility), which expires in December 2021. Subject to certain conditions, we have the right to increase the credit facility to up to $1.5 billion. The credit facility contains a financial covenant requiring us to not exceed a maximum total leverage ratio (the ratio of

consolidated net debt as of the end of the period to consolidated Earnings Before Interest, Income Taxes, Depreciation and Amortization (EBITDA) for such period) of 3.50:1. Upon entering into a material acquisition, the maximum total leverage ratio increases to 4.00:1, and extends until the fourth full consecutive fiscal quarter ended immediately following the consummation of a material acquisition. The credit facility also contains a clause which adds back to Adjusted Consolidated EBITDA, any operational efficiency restructuring charge (defined as charges recorded by the company during the period commencing on October 1, 2016 and ending December 31, 2019, related to operational efficiency initiatives), provided that for any twelve-month period such charges added back to Adjusted Consolidated EBITDA shall not to exceed $100 million in the aggregate.

The credit facility also contains a financial covenant requiring that we maintain a minimum interest coverage ratio (the ratio of EBITDA at the end of the period to interest expense for such period) of 3.50:1. In addition, the credit facility contains other customary covenants.

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We have additional lines of credit and other credit arrangements with a group of banks and other financial intermediaries for general corporate purposes. We maintain cash and cash equivalent balances in excess of our outstanding short-term borrowings. As of July 2, 2017, we had access to $75 million of lines of credit which expire at various times throughout 2017 and 2018 and are generally renewed annually. We did not have any borrowings outstanding related to these facilities as of July 2, 2017 and December 31, 2016.

Commercial Paper Program

In February 2013, we entered into a commercial paper program with a capacity of up to $1.0 billion. As of July 2, 2017, there was $100 million of commercial paper borrowings outstanding, with a weighted average interest rate of 1.4%. As of December 31, 2016, there was no commercial paper issued under this program.

Domestic and international short-term funds

Many of our operations are conducted outside the United States. The amount of funds held in the United States will fluctuate due to the timing of receipts and payments in the ordinary course of business and due to other reasons, such as business development activities. As part of our ongoing liquidity assessments, we regularly monitor the mix of U.S. and international cash flows (both inflows and outflows). Repatriation of overseas funds can result in additional United States, federal, state and local income tax payments. We record U.S. deferred tax liabilities for certain unremitted earnings, but when amounts earned overseas are expected to be indefinitely reinvested outside the United States, no accrual for U.S. taxes is provided.

Global economic conditions

The challenging economic environment has not had, nor do we anticipate that it will have, a significant impact on our liquidity. Due to our operating cash flows, financial assets, access to capital markets and available lines of credit and revolving credit agreements, we continue to believe that we have the ability to meet our liquidity needs for the foreseeable future. As markets change, we continue to monitor our liquidity position. There can be no assurance that a challenging economic environment or a further economic downturn would not impact our ability to obtain financing in the future.

Debt

On November 13, 2015, we issued $1.25 billion aggregate principal amount of our senior notes (2015 senior notes), with an original issue discount of $2 million. On January 28, 2013, we issued $3.65 billion aggregate principal amount of our senior notes (the 2013 senior notes offering) in a private placement, with an original issue discount of $10 million.

The 2013 and 2015 senior notes are governed by an indenture and supplemental indenture (collectively, the indenture) between us and Deutsche Bank Trust Company Americas, as trustee. The indenture contains certain covenants, including limitations on our and certain of our subsidiaries' ability to incur liens or engage in sale leaseback transactions. The indenture also contains restrictions on our ability to consolidate, merge or sell substantially all of our assets. In addition, the indenture contains other customary terms, including certain events of default, upon the occurrence of which the 2013 and 2015 senior notes may be declared immediately due and payable.

Pursuant to the indenture, we are able to redeem the 2013 and 2015 senior notes of any series, in whole or in part, at any time by paying a “make whole” premium, plus accrued and unpaid interest to, but excluding, the date of redemption. Pursuant to our tax matters agreement with Pfizer, we will not be permitted to redeem the 2013 senior notes due 2023 pursuant to this optional redemption provision, except under limited circumstances. Upon the occurrence of a change of control of us and a downgrade of the 2013 and 2015 senior notes below an investment grade rating by each of Moody's Investors Service, Inc. and Standard & Poor's Ratings Services, we are, in certain circumstances, required to make an offer to repurchase all of the outstanding 2013 and 2015 senior notes at a price equal to 101% of the aggregate principal amount of the 2013 and 2015 senior notes together with accrued and unpaid interest to, but excluding, the date of repurchase.

The components of our long-term debt, including current portion of long-term debt, follow:

Description	Principal Amount	Interest Rate	Terms
2013 Senior Note due 2018[(a)]	$750 million	1.875%	Interest due semi annually, not subject to amortization, aggregate principal due on February 1, 2018

2015 Senior Note due 2020	$500 million	3.450%	Interest due semi annually, not subject to amortization, aggregate principal due on November 13, 2020
2013 Senior Note due 2023	$1,350 million	3.250%	Interest due semi annually, not subject to amortization, aggregate principal due on February 1, 2023
2015 Senior Note due 2025	$750 million	4.500%	Interest due semi annually, not subject to amortization, aggregate principal due on November 13, 2025
2013 Senior Note due 2043	$1,150 million	4.700%	Interest due semi annually, not subject to amortization, aggregate principal due on February 1, 2043

(a) We entered into interest rate swaps which are designated as cash flow hedges against interest rate exposure related principally to the anticipated future issuance of fixed-rate debt to be used primarily to refinance our 1.875% 2013 senior note due in 2018. See Notes to Condensed Consolidated Financial Statements— Note 8B. Financial Instruments: Derivative Financial Instruments— Interest Rate Risk.

Credit Ratings

Two major corporate debt-rating organizations, Moody's and S&P, assign ratings to our short-term and long-term debt. A security rating is not a recommendation to buy, sell or hold securities and the rating is subject to revision or withdrawal at any time by the rating organization. Each rating should be evaluated independently of any other rating.

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The following table provides the current ratings assigned by these rating agencies to our commercial paper and senior unsecured non-credit-enhanced long-term debt:

Name of Rating Agency	Commercial Paper Rating	Long-term Debt Rating	Outlook	Date of Last Action
Moody’s	P-2	Baa2	Stable	November 2015
S&P	A-2	BBB	Stable	December 2016

Contractual Obligations

In the first quarter of 2017, we entered into a five-year purchase agreement related to contract manufacturing. Payments due under this purchase obligation as of July 2, 2017, are set forth below:

(MILLIONS OF DOLLARS)	Total	2017	2018 - 2019	2020 - 2021	Thereafter
Purchase obligation	$ 65	$ 9	$ 23	$ 33	$ —

Share Repurchase Program

In December 2016, the company's Board of Directors authorized a $1.5 billion share repurchase program. Purchases of Zoetis shares may be made at the discretion of management, depending on market conditions and business needs. Share repurchases may be executed through various means, including open market or privately negotiated transactions. During the first half of 2017, approximately four million shares were repurchased. As of July 2, 2017, there was approximately $1.3 billion remaining under this authorization.

Off-balance sheet arrangements

In the ordinary course of business and in connection with the sale of assets and businesses, we may indemnify our counterparties against certain liabilities that may arise in connection with a transaction or that are related to activities prior to a transaction. These indemnifications typically pertain to environmental, tax, employee and/or product-related matters, and patent-infringement claims. If the indemnified party were to make a successful claim pursuant to the terms of the indemnification, we would be required to reimburse the loss. These indemnifications are generally subject to threshold amounts, specified claim periods and other restrictions and limitations. Historically, we have not paid significant amounts under these provisions and, as of July 2, 2017, or December 31, 2016, recorded amounts for the estimated fair value of these indemnifications are not significant.

New accounting standards

Recently Issued Accounting Standards Not Adopted as of July 2, 2017.

In March 2017, the FASB issued an accounting standards update to simplify and improve the reporting of net periodic pension benefit cost by requiring only present service cost to be presented in the same line item as other current employee compensation costs while remaining components of net periodic benefit cost would be presented within Other (income)/deductions—net outside of operations. We plan to adopt this guidance as of January 1, 2018, and do not expect the new standard will have a significant impact on our consolidated financial statements.

In October 2016, the Financial Accounting Standards Board (FASB) issued an accounting standards update that will require the recognition of the income tax consequences of an intra-entity asset transfer, other than inventory, when the transfer occurs as opposed to when the asset is sold to an outside third party. The provisions of the new standard are effective beginning January 1, 2018, for annual and interim reporting periods. Early adoption is permitted beginning on January 1, 2017. We plan to adopt this guidance as of January 1, 2018, the required effective date, and do not expect the new standard will have a significant impact on our consolidated financial statements.

In February 2016, the FASB issued an accounting standards update which requires lessees to recognize most leases on the balance sheet with a corresponding right of use asset. Leases will be classified as financing or operating which will drive the expense recognition pattern. For lessees, the income statement presentation and expense recognition pattern for financing and operating leases is similar to the current model for capital and operating leases, respectively. Companies may elect to exclude short-term leases. The update also requires additional disclosures that will better enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases.

We plan to adopt this guidance as of January 1, 2019, the required effective date, for annual and interim reporting periods. The new standard requires a modified retrospective adoption approach, at the beginning of the earliest comparative period presented in the financial statements. We continue to assess the potential impact that adopting this new guidance will have on our consolidated financial statements.

In May 2014, the FASB issued an accounting standards update that outlines a new, single comprehensive model for companies to use in accounting for revenue arising from contracts with customers. This update supersedes most current revenue recognition guidance under U.S. GAAP. The core principle of the new guidance is that an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance includes a five-step model for determining how, when and how much revenue should be recognized. This update also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. We plan to adopt this guidance as of January 1, 2018, the required effective date, using the modified retrospective transition method. Under the modified retrospective method, the cumulative effect of applying the new standard will be recognized as of the date of initial application with disclosure of results under both the new and prior standards. We continue to assess the impact of the new standard on our current policies, procedures, and

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disclosures related to revenue recognition. Based on the work performed to date, we do not believe that the adoption will have a material impact on our consolidated financial statements. While implementation procedures are still ongoing, we have evaluated the impact on our primary revenue stream, product sales, in both the United States and our key international markets and no matters have currently been identified individually or in the aggregate that would have a material impact on the timing or amount of revenue recognition based on the provisions of the new standard.

Forward-looking statements and factors that may affect future results

This report contains "forward-looking" statements. We generally identify forward-looking statements by using words such as "anticipate," "estimate," "could," "expect," "intend," "project," "plan," "predict," "believe," "seek," "continue," "outlo "target", "may," "might," "will," "should," "can have," "likely" or the negative version of these words or comparable words or using future dates in connection with any discussion of future performance, actions or events.

In particular, forward-looking statements include statements relating to our indebtedness, our ability to make interest and principal payments on our indebtedness, our ability to satisfy the covenants contained in our indebtedness, the redemption of our senior notes, new systems infrastructure stand-up, future actions, business plans or prospects, prospective products, product approvals or products under development, product supply disruptions, R&D costs, timing and likelihood of success, future operating or financial performance, future results of current and anticipated products and services, strategies, sales efforts, expenses, production efficiencies, production margins, interest rates, tax rates, changes in tax regimes and laws, foreign exchange rates, growth in emerging markets, the outcome of contingencies, such as legal proceedings, plans related to share repurchases and dividends, our agreements with Pfizer, the expected timing and content of regulatory actions, government regulation and financial results. These statements are not guarantees of future performance, actions or events. Forward-looking statements are subject to risks and uncertainties, many of which are beyond our control, and are based on potentially inaccurate assumptions. Among the factors that could cause actual results to differ materially from past results and future plans and projected future results are the following:

- emerging restrictions and bans on the use of antibacterials in food-producing animals;
- perceived adverse effects on human health linked to the consumption of food derived from animals that utilize our products;
- increased regulation or decreased governmental support relating to the raising, processing or consumption of food-producing animals;
- fluctuations in foreign exchange rates and potential currency controls;
- changes in tax laws and regulations;
- legal factors, including product liability claims, antitrust litigation and governmental investigations, including tax disputes, environmental concerns, commercial disputes and patent disputes with branded and generic competitors, any of which could preclude commercialization of products or negatively affect the profitability of existing products;
- failure to protect our intellectual property rights or to operate our business without infringing the intellectual property rights of others;
- an outbreak of infectious disease carried by animals;
- adverse weather conditions and the availability of natural resources;
- adverse global economic conditions;
- failure of our R&D, acquisition and licensing efforts to generate new products;
- the possible impact of competing products, including generic alternatives, on our products and our ability to compete against such products;
- quarterly fluctuations in demand and costs;
- governmental laws and regulations affecting domestic and foreign operations, including without limitation, tax obligations and changes affecting the tax treatment by the United States of income earned outside the United States that may result from pending and possible future proposals; and
- governmental laws and regulations affecting our interactions with veterinary healthcare providers.

However, there may also be other risks that we are unable to predict at this time. These risks or uncertainties may cause actual results to differ materially from those contemplated by a forward-looking statement. You should not put undue reliance on forward-looking statements. Forward-looking statements speak only as of the date on which they

are made. We undertake no obligation to publicly update forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law or by the rules and regulations of the SEC. You are advised, however, to consult any further disclosures we make on related subjects in our Form 10-Q and 8-K reports and our other filings with the SEC. You should understand that it is not possible to predict or identify all such factors. Consequently, you should not consider the above to be a complete discussion of all potential risks or uncertainties.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

A significant portion of our revenue and costs are exposed to changes in foreign exchange rates. In addition, our outstanding borrowings may be subject to risk from changes in interest rates and foreign exchange rates. The overall objective of our financial risk management program is to seek to minimize the impact of foreign exchange rate movements and interest rate movements on our earnings. We manage these financial exposures through operational means and by using certain financial instruments. These practices may change as economic conditions change.

Foreign exchange risk

Our primary net foreign currency translation exposures are the Australian dollar, Brazilian real, Canadian dollar, euro, and U.K. pound. We seek to manage our foreign exchange risk, in part, through operational means, including managing same-currency revenue in relation to same-currency costs and same-currency assets in relation to same-currency liabilities.

Foreign exchange risk is also managed through the use of foreign currency forward-exchange contracts. These contracts are used to offset the potential earnings effects from mostly intercompany short-term foreign currency assets and liabilities that arise from operations.

Our financial instrument holdings at July 2, 2017, were analyzed to determine their sensitivity to foreign exchange rate changes. The fair values of these instruments were determined using Level 2 inputs. The sensitivity analysis of changes in the fair value of all foreign currency forward-exchange contracts at July 2, 2017, indicates that if the U.S. dollar were to appreciate against all other currencies by 10%, the fair value of these contracts would increase by $46 million, and if the U.S. dollar were to weaken against all other currencies by 10%, the fair value of these contracts would decrease by $39 million. For additional details, see Notes to Condensed Consolidated Financial Statements— Note 8B. Financial Instruments: Derivative Financial Instruments— Foreign Exchange Risk.

Interest rate risk

Our outstanding debt balances are predominantly fixed rate debt. While changes in interest rates will have no impact on the interest we pay on our fixed rate debt, interest on our commercial paper and revolving credit facility will be exposed to interest rate fluctuations. At July 2, 2017, there was $100 million of commercial paper borrowings outstanding and no outstanding principal balance under our revolving credit facility. See Notes to Condensed Consolidated Financial Statements— Note 8B. Financial Instruments: Derivative Financial Instruments— Interest Rate Risk.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

An evaluation was carried out under the supervision and with the participation of the company's management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934). Based upon that evaluation as of July 2, 2017, the company's Chief Executive Officer and Chief Financial Officer concluded that the company's disclosure controls and procedures are effective at a reasonable level of assurance in alerting them in a timely manner to material information required to be disclosed in our periodic reports filed with the SEC.

Changes in Internal Control over Financial Reporting

During our most recent fiscal quarter, there has not been any change in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II — OTHER INFORMATION

Item 1. Legal Proceedings

The information required by this Item is incorporated herein by reference to Notes to Condensed Consolidated Financial Statements—Note 15. Commitments and Contingencies in Part I— Item 1, of this Quarterly Report on Form 10-Q.

Item 1A. Risk Factors

In addition to the other information set forth in this Form 10-Q, you should carefully consider the factors discussed in the "Our Operating Environment" and "Forward-Looking Statements and Factors That May Affect Future Results" sections of the MD&A and in Part I, Item 1A. "Risk Factors," of our 2016 Annual Report on Form 10-K, which could materially affect our business, financial condition, or future results and which are incorporated by reference herein. Set forth below are updates to certain of the risk factors disclosed in our 2016 Annual Report on Form 10-K.

Risks related to our business and industry

Restrictions and bans on the use of antibacterials in food-producing animals may become more prevalent.

The issue of the potential transfer of increased antibacterial resistance in bacteria from food-producing animals to human pathogens, and the causality of that transfer, continue to be the subject of global scientific and regulatory discussion. Antibacterials refer to small molecules that can be used to treat or prevent bacterial infections and are a sub-categorization of the products that make up our anti-infectives and medicated feed additives portfolios. In some countries, this issue has led to government restrictions and bans on the use of specific antibacterials in some food-producing animals, regardless of the route of administration (in feed or injectable). These restrictions are more prevalent in countries where animal protein is plentiful and governments are willing to take action even when there is scientific uncertainty. Our total revenue attributable to antibacterials for livestock was approximately $1.3 billion for the year ended December 31, 2016.

For example, in December 2013, the FDA announced final guidance establishing procedures for the voluntary phase-out in the United States over a three-year period of the use of medically important antibacterials in animal feed for growth promotion in food production animals (medically important antibacterials include classes that are prescribed in animal and human health). The guidance provides for continued use of antibacterials in food producing animals for treatment, control and under certain circumstances for prevention of disease, all under the supervision of a veterinarian. The FDA indicated that it took this action to help preserve the efficacy of medically important antibacterials to treat infections in humans. As part of those efforts, stricter regulations governing the administration of medically important antibiotics have recently come into effect. As of January 1, 2017, the use of medically important antibiotics in the water or feed of food production animals now requires written authorization by a licensed veterinarian under the FDA guidance and the related rule known as the Veterinary Feed Directive. As a result of the implementation by livestock producers of the FDA’s guidance and the Veterinary Feed Directive, we have seen a negative impact on revenue in the U.S. on certain medicated feed additive products for both cattle and swine in the first half of 2017 and expect this trend to continue for the remainder of 2017. If these regulations continue to negatively affect our U.S. cattle and swine medicated feed additive revenue, our future operating results could be negatively impacted.

In addition, in October 2014, the French Parliament passed a law that prohibits rebates and discounts on antibiotics and requires the reporting of antibiotics sold to and agreements entered into with certain animal healthcare providers (including veterinarians, veterinary schools, pharmacists and students). The Parliament indicated that the law is in response to a government initiative aimed at fighting antimicrobial resistance in animals and reducing the use of certain categories of antibiotics by 25% (compared to 2013) by December 31, 2016.

We cannot predict whether antibacterial resistance concerns will result in additional restrictions or bans, expanded regulations or public pressure to discontinue or reduce use of antibacterials in food-producing animals, any of which could materially adversely affect our operating results and financial condition.

Generic products may be viewed as more cost-effective than our products.

We face competition from products produced by other companies, including generic alternatives to our products. We depend on patents and regulatory data exclusivity periods to provide us with exclusive marketing rights for some of our products. Patents for individual products expire at different times based on the date of the patent filing (or

sometimes the date of patent grant) and the legal term of patents in the countries where such patents are obtained. The extent of protection afforded by our patents varies from country to country and is limited by the scope of the claimed subject matter of our patents, the term of the patent and the availability and enforcement of legal remedies in the applicable country. As a result, we may face competition from lower-priced generic alternatives to many of our products. Generic competitors are becoming more aggressive in terms of launching at risk before patent rights expire and, because of their pricing, are an increasing percentage of overall animal health sales in certain regions. For example, several companies have launched generic versions of our Rimadyl chewable product. As a result, sales of our Rimadyl chewable product in the U.S. decreased by approximately 6% in 2016. If animal health customers increase their use of new or existing generic products, our operating results and financial condition could be materially adversely affected.

Over the next several years, several of our products' patents will expire. The active ingredient of Draxxin, tulathromycin, is covered by both compound and formulation patents in the United States, Europe, Canada, Australia and other key markets, with terms that expire between May 2019 and January 2021 in the United States, between November 2018 and November 2020 in Europe, and between May 2018 and November 2020 in Canada and Australia. Several patents covering the ceftiofur antibiotic product line (Excede) began expiring in the United States in 2015. However, various formulation and use patents relevant to the product line extend through to 2024. The compound patent for the selamectin, the active ingredient in our parasiticide Revolution, expired in 2014. Again, we have process and formulation patents covering this product which expire in important markets in 2018 and 2019, respectively. The patent for the active ingredient of Convenia has expired, however, there are formulation patents relevant to the product line which expire between November 2022 and September 2023. The patent for the active ingredient of Cerenia has expired in Europe and other countries but does not expire in the United States until December 2017. However, there are formulation patents relevant to the product line which expire between May 2020 and January 2027. A generic version of Cerenia has recently been registered in Europe. The patent relating to the formulation of Orbeseal expires in December 2017. Zoetis typically enforces all of its patents.

Risks related to tax matters

The Company could be subject to changes in its tax rates, the adoption of new U.S. or foreign tax legislation or exposure to additional tax liabilities.

The multinational nature of our business subjects us to taxation in the United States and numerous foreign jurisdictions. Due to economic and political conditions, tax rates in various jurisdictions may be subject to significant change. The company’s future effective tax rates could be affected by changes in the mix of earnings in countries with differing statutory tax rates, changes in the valuation of deferred tax assets and liabilities, or changes in tax laws or their interpretation.

For example, the European Commission opened formal investigations to examine whether decisions by the tax authorities in certain European countries, including Belgium, comply with European Union rules on state aid. In the case of Belgium, the European Commission concluded on January 11, 2016, that the excess profits ruling violates the European Union’s state aid rules. The impact of this conclusion was a net tax charge of approximately $35 million recorded in 2016. This net charge relates to the Belgium government's recovery of benefits for the periods 2013 through 2015 offset by the revaluation of the company’s deferred tax assets and liabilities using the rates expected to be in place at the time of the reversal and without consideration of implementation of any future operational changes, and does not include any benefits associated with a successful appeal of the decision.

In addition, on June 20, 2016, the Member States of the European Union adopted the anti-tax-avoidance directive proposed on January 28, 2016, which is designed to provide uniform implementation of Base Erosion and Profits Shifting measures and other minimum taxation standards across Member States. The Member States are required to implement all components of the directive by January 1, 2020. Once enacted by the Member States, the results of the directive could have an impact on our effective tax rate. In October 2016, the European Union also introduced a proposal to impose a uniform set of rules on taxing corporate profits, known as the Common Consolidated Corporate Tax Base. This proposal is in its early stages but may have an impact to our effective tax rate.

The new administration in the United States has called for comprehensive tax reform in the U.S. which, among other things, might change certain U.S. tax rules impacting the way U.S. based multinationals are taxed on foreign income. Changes to the tax system in the United States, particularly the potential mandatory deemed repatriation tax, could have a material impact to our financial statements. As of December 31, 2016, the cumulative amount of non-U.S. undistributed earnings was approximately $7.4 billion. Of this cumulative amount, Zoetis was allocated $6.4 billion in non-U.S. undistributed earnings from Pfizer as a result of the separation on June 24, 2013, with minimal cash associated with these earnings. The potential impact of the mandatory deemed repatriation proposal is uncertain as the direction of comprehensive tax reform is being contemplated under the new administration in the United States. At this time, we are properly reflecting the provision for taxes on income using all current enacted global tax laws in every jurisdiction in which we operate.

On March 29, 2017, United Kingdom (UK) Prime Minister Theresa May formally notified the European Council of the UK’s intention to withdraw from the European Union, commonly referred to as “Brexit”, under Article 50 of the Treaty of Lisbon. The notice begins the two-year negotiation period to establish the withdrawal terms. If no agreement

is reached after two years, the UK's separation still becomes effective, unless the remaining European Union members unanimously agree to an extension. At this time, the impact of Brexit to our effective tax rate is uncertain.

In addition, our effective tax rate is subject to potential risks that various taxing authorities may challenge the pricing of our cross-border arrangements and subject us to additional tax, adversely impacting our effective tax rate and our tax liability. The company is also subject to the examination of its tax returns and other tax matters by the Internal Revenue Service and other tax authorities and governmental bodies. The company regularly assesses the likelihood of an adverse outcome resulting from these examinations to determine the adequacy of its provision for taxes. There can be no assurance as to the outcome of these examinations. If the company's effective tax rates were to increase, particularly in the United States or other material foreign jurisdictions, or if the ultimate determination of the company's taxes owed is for an amount in excess of amounts previously accrued, the company's operating results, cash flows and financial condition could be adversely affected.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table provides information with respect to the shares of the company’s common stock repurchased during the quarter ended July 2, 2017:

	Issuer Purchases of Equity Securities			
	Total Number of Shares Purchased[(a)]	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Programs[(b)]	Approximate Dollar Value of Shares that May Yet Be Purchased Under Plans or Programs
April 3 - April 30, 2017	650,736	$53.39	643,780	$1,340,810,236
May 1 - May 28, 2017	720,946	$58.58	719,971	$1,298,619,801
May 29 - July 2, 2017	773,245	$62.63	772,520	$1,250,227,170
	2,144,927	$58.46	2,136,271	$1,250,227,170

(a) The company repurchased 8,656 shares during the three-month period ended July 2, 2017, that were not part of the publicly announced share repurchase authorization. These shares were reacquired from employees to satisfy tax withholding requirements on the vesting of restricted shares from equity-based awards.

(b) In December 2016, the company's Board of Directors authorized the repurchase of up to $1.5 billion of our outstanding common stock.

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

None

Item 5. Other Information

None

Item 6. Exhibits

Exhibit 3.1	Restated Certificate of Incorporation of the Registrant, effective as of May 13, 2014 (incorporated by reference to Exhibit 3.1 to Zoetis Inc.'s Quarterly Report on Form 10-Q filed on November 10, 2014 (File No. 001-35797))
Exhibit 3.2	By-laws of the Registrant, amended and restated as of February 19, 2016 (incorporated by reference to Exhibit 3.2 to Zoetis Inc.'s 2015 Annual Report on Form 10-K filed on February 24, 2016 (File No. 001-35797))
Exhibit 12	Computation of Ratio of Earnings to Fixed Charges
Exhibit 15	Accountants' Acknowledgment
Exhibit 31.1	Chief Executive Officer–Certification pursuant to Sarbanes-Oxley Act of 2002 Section 302
Exhibit 31.2	Chief Financial Officer–Certification pursuant to Sarbanes-Oxley Act of 2002 Section 302
Exhibit 32.1	Chief Executive Officer–Certification pursuant to Sarbanes-Oxley Act of 2002 Section 906
Exhibit 32.2	Chief Financial Officer–Certification pursuant to Sarbanes-Oxley Act of 2002 Section 906
EX-101.INS	INSTANCE DOCUMENT
EX-101.SCH	SCHEMA DOCUMENT
EX-101.CAL	CALCULATION LINKBASE DOCUMENT
EX-101.LAB	LABELS LINKBASE DOCUMENT
EX-101.PRE	PRESENTATION LINKBASE DOCUMENT
EX-101.DEF	DEFINITION LINKBASE DOCUMENT

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Zoetis Inc.

August 8, 2017 By: /S/ JUAN RAMÓN ALAIX
Juan Ramón Alaix
Chief Executive Officer and Director

August 8, 2017 By: /S/ GLENN DAVID
Glenn David
Executive Vice President and
Chief Financial Officer