Zoetis Inc.
Form 10-Q
August 02, 2018
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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 June 30, 2018
or
TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

¨ For the transition period from _____ to _____
Commission File 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 July 27, 2018, there were 481,823,803 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)	June 30, 2018	July 2, 2017	June 30, 2018	July 2, 2017
Revenue	$1,415	$1,269	$2,781	$2,500
Costs and expenses:				
Cost of sales	447	440	894	883
Selling, general and administrative expenses	359	336	697	645
Research and development expenses	102	86	199	176
Amortization of intangible assets	23	23	46	45
Restructuring charges/(reversals) and certain acquisition-related costs	5	—	7	(1)
Interest expense, net of capitalized interest	46	41	93	82
Other (income)/deductions—net	(4)	(2)	(9)	(12)
Income before provision for taxes on income	437	345	854	682
Provision for taxes on income	55	98	122	196
Net income before allocation to noncontrolling interests	382	247	732	486
Less: Net (loss)/income attributable to noncontrolling interests	(2)	—	(4)	1
Net income attributable to Zoetis Inc.	$384	$247	$736	$485
Earnings per share attributable to Zoetis Inc. stockholders:				
Basic	$0.79	$0.50	$1.52	$0.99
Diluted	$0.79	$0.50	$1.51	$0.98
Weighted-average common shares outstanding:				
Basic	483.8	490.8	484.8	491.6
Diluted	487.5	494.0	488.6	494.6
Dividends declared per common share	$0.126	$0.105	$0.252	$0.210

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)	June 30, 2018	July 2, 2017	June 30, 2018	July 2, 2017
Net income before allocation to noncontrolling interests	$382	$247	$732	$486
Other comprehensive (loss)/income, net of taxes and reclassification adjustments:				
Unrealized losses on derivatives, net[(a)]	—	(1)	—	(1)
Foreign currency translation adjustments, net	(115)	12	(38)	56
Benefit plans: Actuarial (losses)/gains, net[(a)]	—	(1)	—	1
Total other comprehensive (loss)/income, net of tax	(115)	10	(38)	56
Comprehensive income before allocation to noncontrolling interests	267	257	694	542
Less: Comprehensive (loss)/income attributable to noncontrolling interests	(3)	—	(4)	1
Comprehensive income attributable to Zoetis Inc.	$270	$257	$698	$541

(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 Other (income)/deductions, beginning in the first quarter of 2018, and into Cost of sales, Selling, general and administrative expenses, and/or Research and development expenses, as appropriate, for periods prior to 2018, 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)	June 30, 2018 (Unaudited)	December 31, 2017
Assets		
Cash and cash equivalents[(a)]	$ 1,558	$ 1,564
Accounts receivable, less allowance for doubtful accounts of $24 in 2018 and $25 in 2017	973	998
Inventories	1,420	1,427
Other current assets	288	228
Total current assets	4,239	4,217
Property, plant and equipment, less accumulated depreciation of $1,522 in 2018 and $1,471 in 2017	1,470	1,435
Goodwill	1,514	1,510
Identifiable intangible assets, less accumulated amortization	1,225	1,269
Noncurrent deferred tax assets	80	80
Other noncurrent assets	75	75
Total assets	$ 8,603	$ 8,586
Liabilities and Equity		
Accounts payable	230	261
Dividends payable	61	61
Accrued expenses	434	432
Accrued compensation and related items	160	236
Income taxes payable	53	60
Other current liabilities	29	44
Total current liabilities	967	1,094
Long-term debt, net of discount and issuance costs	4,955	4,953
Noncurrent deferred tax liabilities	229	380
Other taxes payable	266	172
Other noncurrent liabilities	204	201
Total liabilities	6,621	6,800
Commitments and contingencies (Note 16)		
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; 482,290,154 and 486,130,461 shares outstanding at June 30, 2018, and December 31, 2017, respectively	5	5
Treasury stock, at cost, 19,601,089 and 15,760,782 shares of common stock at June 30, 2018, and December 31, 2017, respectively	(1,215)	(852)
Additional paid-in capital	1,001	1,013
Retained earnings	2,722	2,109
Accumulated other comprehensive loss	(543)	(505)
Total Zoetis Inc. equity	1,970	1,770
Equity attributable to noncontrolling interests	12	16
Total equity	1,982	1,786
Total liabilities and equity	$ 8,603	$ 8,586

(a) As of June 30, 2018, and December 31, 2017, includes $5 million and $6 million, respectively, 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, 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[b]	—	—	—	—	—	18	18
Share-based compensation awards[c]	—	56	(1)	(16)	—	—	39
Treasury stock acquired[d]	—	(250)	—	—	—	—	(250)
Employee benefit plan contribution from Pfizer Inc.[e]	—	—	1	—	—	—	1
Dividends declared	—	—	—	(103)	—	—	(103)
Balance, July 2, 2017	$ 5	$(615)	$ 1,024	$ 1,843	$ (542)	$ 31	$ 1,746
Balance, December 31, 2017	$ 5	$(852)	$ 1,013	$ 2,109	$ (505)	$ 16	$ 1,786
Six months ended June 30, 2018							
Net income/(loss)	—	—	—	736	—	(4)	732
Other comprehensive income	—	—	—	—	(38)	—	(38)
Share-based compensation awards [c]	—	42	(13)	(1)	—	—	28
Treasury stock acquired[d]	—	(405)	—	—	—	—	(405)
Employee benefit plan contribution from Pfizer Inc.[e]	—	—	1	—	—	—	1
Dividends declared	—	—	—	(122)	—	—	(122)
Balance, June 30, 2018	$ 5	$(1,215)	$ 1,001	$ 2,722	$ (543)	$ 12	$ 1,982

(a) As of June 30, 2018, and July 2, 2017, there were 482,290,154 and 489,659,511 outstanding shares of common stock, respectively, and 19,601,089 and 12,231,732 shares of treasury stock, respectively. Treasury stock is recognized at the cost to reacquire the shares. For additional information, see Note 14. Stockholders' Equity.

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

(c) 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 13. Share-Based Payments and Note 14. Stockholders' Equity.

(d) Reflects the acquisition of treasury shares in connection with the share repurchase program. For additional information, see Note 14. Stockholders' Equity.

(e) 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 12. Benefit Plans.

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 June 30, 2018	July 2, 2017
Operating Activities		
Net income before allocation to noncontrolling interests	$732	$486
Adjustments to reconcile net income before noncontrolling interests to net cash provided by operating activities:		
Depreciation and amortization expense	123	121
Share-based compensation expense	22	22
Restructuring	7	(1)
Asset write-offs and asset impairments	7	—
Net loss on sale of assets	—	2
Provision for losses on inventory	25	40
Deferred taxes[(a)]	(155)	13
Employee benefit plan contribution from Pfizer Inc.	1	1
Other non-cash adjustments	4	—
Other changes in assets and liabilities, net of acquisitions and divestitures		
Accounts receivable	(9)	(41)
Inventories	(23)	(46)
Other assets	(63)	(106)
Accounts payable	(28)	(66)
Other liabilities	(75)	(147)
Other tax accounts, net[(a)]	88	21
Net cash provided by operating activities	656	299
Investing Activities		
Purchases of property, plant and equipment	(126)	(93)
Acquisitions	—	(3)
Net proceeds from sales of assets	8	1
Other investing activities	(3)	7
Net cash used in investing activities	(121)	(88)
Financing Activities		
Issuance of commercial paper	—	100
Payment of contingent consideration related to previously acquired assets	(12)	(5)
Share-based compensation-related proceeds, net of taxes paid on withholding shares	6	18
Purchases of treasury stock	(405)	(250)
Cash dividends paid	(122)	(103)
Net cash used in financing activities	(533)	(240)
Effect of exchange-rate changes on cash and cash equivalents	(8)	7
Net increase/(decrease) in cash and cash equivalents	(6)	(22)
Cash and cash equivalents at beginning of period	1,564	727
Cash and cash equivalents at end of period	$1,558	$705
Supplemental cash flow information		
Cash paid during the period for:		

Income taxes	$221	$256
Interest, net of capitalized interest	96	82
Non-cash transactions:		
Purchases of property, plant and equipment	3	3
Dividends declared, not paid	61	52

(a) Reflects the reclassification of the one-time mandatory deemed repatriation tax from Noncurrent deferred tax liabilities to Income taxes payable and Other taxes payable to properly reflect the liability, which became a fixed obligation in 2018 payable over eight years.

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: vaccines, anti-infectives, 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 six-month periods ended May 31, 2018, and May 28, 2017.

Prior to fiscal 2018, the company followed a 13-week quarterly accounting cycle for each of the first three fiscal quarters. The company's fiscal year ends on December 31 for our operations in the United States and on November 30 for subsidiaries operating outside the United States. Beginning in fiscal 2018, the company's first three fiscal quarters will end on the last day of March, June and September in the United States and the last day of February, May and August for subsidiaries operating outside the United States. There is no change to the company's fiscal year-end dates. We did not adjust our results of operations for periods prior to 2018 as the impact was not material.

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 2017 Annual Report on Form 10-K.

3. Accounting Standards

Recently Adopted Accounting Standards

In March 2018, the Financial Accounting Standards Board (FASB) issued an accounting standards update to align existing guidance on accounting for income taxes, pursuant to guidance provided by a Staff Accounting Bulletin published by the SEC on December 22, 2017. The update addresses the challenges in accounting for the effects of the Tax Cuts and Jobs Act (the Tax Act), enacted on December 22, 2017, in the period of enactment and required companies to report provisional amounts for those specific income tax effects of the Tax Act for which the accounting is incomplete but a reasonable estimate can be determined. Provisional amounts will be subject to adjustment during a measurement period of up to one year from the enactment date. For additional information, see Note 8. Income Taxes.

In August 2017, the FASB issued an accounting standards update which amends the hedge accounting recognition and presentation requirements

and is intended to better align hedge accounting with companies' risk management strategies. The standard eliminates the requirement to separately measure and report hedge ineffectiveness and generally requires that the entire change in fair value of a hedging instrument be presented in the same income statement line item as the respective hedged item. The standard also modifies certain disclosure requirements. The provisions of the update are effective beginning January 1, 2019 for interim and annual periods with early adoption permitted for any interim period after issuance of

the update. We elected to early adopt this guidance as of April 1, 2018. There were no hedging contracts in effect as of the date of adoption.

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 adopted this guidance as of January 1, 2018, the required effective date. The new standard did not have a significant impact on our consolidated financial statements.

In October 2016, the FASB issued an accounting standards update that requires 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. We adopted this

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guidance as of January 1, 2018, the required effective date. The new standard did not have a significant impact 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. 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. We adopted this guidance as of January 1, 2018, the required effective date, using the modified retrospective adoption method. Prior period amounts have not been adjusted and continue to be reported in accordance with our historic accounting policies. Application of the standard using the modified retrospective method did not require an adjustment to opening retained earnings. For additional information, see Note 4. Revenue.

Recently Issued Accounting Standards

In February 2018, the FASB issued an accounting standards update which permits companies to reclassify from accumulated other comprehensive income to retained earnings stranded tax effects resulting from the new federal corporate income tax rate. In the period of adoption, a company may choose to either apply the amendments retrospectively to each period in which the effect of the change in federal income tax rate is recognized or to apply the amendments in that reporting period. The provisions of the update are effective beginning January 1, 2019 for interim and annual periods, with early adoption permitted for any interim period after issuance of the update. We are currently assessing the timing of our adoption and do not expect that 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 have selected a lease accounting system which we are in the process of implementing, while continuing to evaluate our lease contracts, accounting policy elections, and the impact of adoption on our consolidated financial statements. While we do not expect adoption of the standard to have a significant impact on our consolidated statements of income, the impact on the assets and liabilities within our consolidated balance sheet may be material.

4. Revenue

A. Revenue from Product Sales

We offer a diversified portfolio of products which allows us to capitalize on local and regional customer needs. Generally, our products are promoted to veterinarians and livestock producers by our sales organization which includes sales representatives and technical and veterinary operations specialists, and then sold directly by us or through distributors. The depth of our product portfolio enables us to address the varying needs of customers in different species and geographies. Many of our top selling product lines are distributed across both of our operating segments, leveraging our R&D operations and manufacturing and supply chain network.

Over the course of our history, we have focused on developing a diverse portfolio of animal health products, including medicines and vaccines, complemented by biodevices, diagnostics, and genetics. We refer to a single product in all brands, or its dosage forms for all species, as a product line. We have approximately 300 comprehensive product lines, including products for both livestock and companion animals across each of our major product categories.

Our major product categories are:

- vaccines: biological preparations that help prevent diseases of the respiratory, gastrointestinal and reproductive tracts or induce a specific immune response;
- anti-infectives: products that prevent, kill or slow the growth of bacteria, fungi or protozoa;
-

other pharmaceutical products: allergy and dermatology, pain and sedation, antiemetic, reproductive, and oncology products;

- parasiticides: products that prevent or eliminate external and internal parasites such as fleas, ticks and worms; and
- medicated feed additives: products added to animal feed that provide medicines to livestock.

Our remaining revenue is derived from other non-pharmaceutical product categories, such as nutritionals and agribusiness, as well as products and services in complementary areas, including biodevices, diagnostics and genetics.

Our livestock products primarily help prevent or treat diseases and conditions to enable the cost-effective production of safe, high-quality animal protein. Human population growth and increasing standards of living are important long-term growth drivers for our livestock products in three major ways. First, population growth and increasing standards of living drive increased demand for improved nutrition, particularly animal protein. Second, population growth leads to increased natural resource constraints driving a need for enhanced productivity. Finally, as standards of living improve, there is increased focus on food quality and safety.

Our companion animal products help extend and improve the quality of life for pets; increase convenience and compliance for pet owners; and help veterinarians improve the quality of their care and the efficiency of their businesses. Growth in the companion animal medicines

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and vaccines sector is driven by economic development, related increases in disposable income and increases in pet ownership and spending on pet care. Companion animals are also living longer, receiving increased medical treatment and benefiting from advances in animal health medicines and vaccines.

The following tables present our revenue disaggregated by geographic area, species, and major product category.

Revenue by geographic area

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	June 30, 2018	July 2, 2017	June 30, 2018	July 2, 2017
United States	$677	$623	$1,311	$1,228
Australia	51	43	99	83
Brazil	68	73	138	139
Canada	56	49	96	83
China	60	45	124	97
France	30	26	63	55
Germany	38	33	76	61
Italy	26	21	53	43
Japan	39	36	80	70
Mexico	26	21	50	39
Spain	30	23	55	43
United Kingdom	36	26	88	69
Other developed markets	89	76	168	144
Other emerging markets	179	162	364	323
	1,405	1,257	2,765	2,477
Contract Manufacturing	10	12	16	23
Total Revenue	$1,415	$1,269	$2,781	$2,500

Revenue by major species

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	June 30, 2018	July 2, 2017	June 30, 2018	July 2, 2017
U.S.				
Livestock	$271	$269	$563	$551
Companion Animal	406	354	748	677
	677	623	1,311	1,228
International				
Livestock	463	420	941	841
Companion Animal	265	214	513	408
	728	634	1,454	1,249
Contract Manufacturing	10	12	16	23
Total Revenue	$1,415	$1,269	$2,781	$2,500

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Revenue by species

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	June 30, 2018	July 2, 2017	June 30, 2018	July 2, 2017
Livestock:				
Cattle	$396	$382	$812	$768
Swine	165	148	340	308
Poultry	129	122	265	238
Fish	24	19	46	40
Other	20	18	41	38
	734	689	1,504	1,392
Companion Animal:				
Dogs and Cats	630	533	1,179	1,015
Horses	41	35	82	70
	671	568	1,261	1,085
Contract Manufacturing	10	12	16	23
Total Revenue	$1,415	$1,269	$2,781	$2,500

Revenue by major product category

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	June 30, 2018	July 2, 2017	June 30, 2018	July 2, 2017
Vaccines	$371	$324	$727	$643
Anti-infectives	286	278	583	546
Other pharmaceuticals	337	282	656	554
Parasiticides	245	206	436	390
Medicated feed additives	114	121	251	244
Other non-pharmaceuticals	52	46	112	100
	1,405	1,257	2,765	2,477
Contract Manufacturing	10	12	16	23
Total Revenue	$1,415	$1,269	$2,781	$2,500

B. Revenue Accounting Policy

Below are the significant accounting policies updated as of January 1, 2018 as a result of the adoption of the new revenue recognition guidance. For additional information, see Note 3. Accounting Standards.

We recognize revenue from product sales when control of the goods has transferred to the customer, which is typically once the goods have shipped and the customer has assumed title. Revenue reflects the total consideration to which we expect to be entitled (i.e. the transaction price), in exchange for products sold, after considering various types of variable consideration including rebates, sales allowances, product returns and discounts.

Variable consideration is estimated and recorded at the time that related revenue is recognized. Our estimates reflect the amount by which we expect variable consideration to impact revenue recognized and are generally based on contractual terms or historical experience, adjusted as necessary to reflect our expectations about the future. Our customer payment terms generally range from 60 to 90 days.

Estimates of variable consideration utilize a complex series of judgments and assumptions to determine the amount by which we expect revenue to be reduced, for example;

- for sales returns, we perform calculations in each market that incorporate the following, as appropriate: local returns policies and practices; historic returns as a percentage of revenue; estimated shelf life by product; an estimate of the amount of time between shipment and return or lag time; and any other factors that could impact the estimate of future returns, product recalls, discontinuation of products or a changing competitive environment; and
- for revenue incentives, we use our historical experience with similar incentives programs to estimate the impact of such programs on revenue for the current period.

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Although the amounts recorded for these revenue deductions are dependent on estimates and assumptions, historically our adjustments to actual results have not been material. The sensitivity of our estimates can vary by program, type of customer and geographic location.

A deferral of revenue may be required in the event that we have not satisfied all customer obligations for which we have been compensated. The transaction price is allocated to the individual performance obligations on the basis of relative stand-alone selling price, which is typically based on actual sales prices. Revenue associated with unsatisfied performance obligations are contract liabilities, is recorded within Other current liabilities, and is recognized once control of the underlying products has transferred to the customer. Contract liabilities reflected within Other current liabilities as of the adoption date and subsequently recognized as revenue during the first six months of 2018 were approximately $2 million. Contract liabilities as of June 30, 2018 were approximately $3 million.

We do not disclose the transaction price allocated to unsatisfied performance obligations related to contracts with an original expected duration of one year or less, or for contracts for which we recognize revenue in line with our right to invoice the customer. Estimated future revenue expected to be generated from long-term contracts with unsatisfied performance obligations as of June 30, 2018 are not material.

Taxes collected from customers relating to product sales and remitted to governmental authorities are excluded from Revenue. Shipping and handling costs incurred after control of the purchased product has transferred to the customer are accounted for as a fulfillment cost, within Selling, general and administrative expenses.

5. 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 February 12, 2016 sale of two of our manufacturing sites in the United Sates: Laurinburg, North Carolina, and Longmonth, Colorado to Huvepharma NV (Huvepharma), a European animal health company.

6. 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 the consolidated company, which may include charges related to employees, assets and activities that will not continue in the consolidated company. 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.

During 2015, we launched a comprehensive operational efficiency program, which was incremental to the previously announced supply network strategy. These initiatives focused on reducing complexity in our product portfolios, changing our selling approach in certain markets, reducing our presence in certain countries, and exiting manufacturing sites over a long term period. We have also continued 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. The comprehensive operational efficiency program was substantially completed as of December 31, 2017. We expect to complete the supply network strategy over the next several years.

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)	June 30, 2018	July 2, 2017	June 30, 2018	July 2, 2017
Restructuring charges/(reversals) and certain acquisition-related costs:				
Integration costs[a]	$—	$ 2	$ 1	$ 2
Restructuring charges/(reversals)[b][c]:				
Employee termination costs/(reversals)	4	(3)	5	(4)
Exit costs	1	1	1	1
Total Restructuring charges/(reversals) and certain acquisition-related costs	$ 5	$ —	$ 7	$ (1)

(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 for the three months ended June 30, 2018, are primarily related to:

- employee termination costs of $3 million in Europe as a result of initiatives to better align our organizational structure, and
- employee termination costs of $1 million and exit costs of $1 million as a result of our operational efficiency initiative and supply network strategy.

The restructuring charges for the six months ended June 30, 2018, are primarily related to:

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- employee termination costs of $3 million in Europe as a result of initiatives to better align our organizational structure, and
- employee termination costs of $2 million and exit costs of $1 million as a result of our operational efficiency initiative and supply network strategy.

The restructuring charges/(reversals) for the three and six months ended July 2, 2017, primarily relate to our operational efficiency initiative and supply network strategy.

(c) The restructuring charges/(reversals) are associated with the following:

- For the three months ended June 30, 2018, International of $4 million and Manufacturing/research/corporate of $1 million.
- For the six months ended June 30, 2018, International of $4 million and Manufacturing/research/corporate of $2 million.
- For the three months ended July 2, 2017, U.S. of ($1 million), International of $1 million and Manufacturing/research/corporate of ($2 million).
- For the six months ended July 2, 2017, International of ($1 million) and Manufacturing/research/corporate of ($2 million).

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

(MILLIONS OF DOLLARS)	Three Months Ended June 30, 2018	Three Months Ended July 2, 2017	Six Months Ended June 30, 2018	Six Months Ended July 2, 2017
Restructuring charges/(reversals) and certain acquisition-related costs:				
Operational efficiency initiative				
Employee termination costs	$ 1	$ 2	$ 1	$ 1
Exit costs	—	1	—	1
	1	3	1	2
Supply network strategy:				
Employee termination costs	—	(5)	1	(5)
Exit costs	1	—	1	—
	1	(5)	2	(5)
Total restructuring charges/(reversals) related to the operational efficiency initiative and supply network strategy	2	(2)	3	(3)
Other operational efficiency initiative charges				
Selling, general and administrative expenses:				
Consulting fees	—	1	—	1
Other (income)/deductions—net:				
Net (gain)/loss on sale of assets	—	2	—	2
Total other operational efficiency initiative charges	—	3	—	3
Other supply network strategy charges				
Cost of sales:				
Accelerated depreciation	—	1	—	2
Consulting fees	2	—	3	2
Total other supply network strategy charges	2	1	3	4
Total charges associated with the operational efficiency initiative and supply network strategy	$ 4	$ 2	$ 6	$ 4

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

(MILLIONS OF DOLLARS)	Employee Termination Costs	Exit Costs	Accrual
Balance, December 31, 2017[a]	$ 41	$ —	$ 41
Provision	5	1	6
Utilization and other[b]	(12)	(1)	(13)
Balance, June 30, 2018[a]	$ 34	$ —	$ 34

(a) At June 30, 2018, and December 31, 2017, included in Accrued expenses ($12 million and $19 million, respectively) and Other noncurrent liabilities ($22 million and $22 million, respectively).

(b) Includes adjustments for foreign currency translation.

7. Other (Income)/Deductions—Net

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

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	June 30, 2018	July 2, 2017	June 30, 2018	July 2, 2017
Royalty-related income	$(6)	$ (5)	$(13)	$(12)
Net loss/(gain) on sale of assets[a]	—	2	—	2
Certain legal and other matters, net[b]	—	(4)	—	(4)
Foreign currency loss[c]	9	8	17	10
Other, net[d]	(7)	(3)	(13)	(8)
Other (income)/deductions—net	$(4)	$ (2)	$(9)	$(12)

(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.

(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 three and six months ended June 30, 2018, primarily includes interest 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.

8. Income Taxes

A. Taxes on Income

On December 22, 2017, the Tax Act was enacted which, among other changes, reduced the U.S. federal corporate tax rate from 35% to 21% effective January 1, 2018. The Tax Act made broad and complex changes to the U.S. tax code and it will take time to fully analyze the impact of the changes. Based on the information available at that time, and the current interpretation of the Tax Act, for the year ended December 31, 2017 the company was able to make a reasonable estimate and recorded an initial provisional net tax expense of $212 million related to the one-time mandatory deemed repatriation tax, payable over eight years, partially offset by the remeasurement of the deferred tax assets and liabilities, as of the date of enactment, due to the reduction in the U.S. federal corporate tax rate. Pursuant to the Staff Accounting Bulletin published by the SEC on December 22, 2017, addressing the challenges in accounting for the effects of the Tax Act in the period of enactment, companies must report provisional amounts for those specific income tax effects of the Tax Act for which the accounting is incomplete but a reasonable estimate can be determined. Those provisional amounts will be subject to adjustment during a measurement period of up to one year from the enactment date (measurement-period adjustment). Pursuant to this guidance, the estimated impact of the Tax Act was based on a preliminary review of the new tax law and projected future financial results and is subject to revision based upon further analysis and interpretation of the Tax Act and to the extent that future results differ from currently available projections.

Our accounting for the following elements of the Tax Act is incomplete. However, in 2018 we were able to further refine our initial reasonable estimate and adjusted the initial provisional net tax expense of $212 million. We recorded the following measurement-period adjustments of $33 million and $35 million net tax benefit during the three and six months ended June 30, 2018, respectively:

- One-Time Mandatory Deemed Repatriation Tax: The one-time mandatory deemed repatriation tax is imposed on certain previously untaxed accumulated and current earnings and profits (E&P) of our foreign subsidiaries. We were able to reasonably estimate the one-time mandatory deemed repatriation tax and recorded an initial provisional tax obligation, with a corresponding adjustment to income tax expense for the year ended December 31, 2017. We are continuing to gather additional information to more precisely compute the amount of the one-time mandatory deemed repatriation tax, and our accounting for this item is not yet complete due to the fact that the non-U.S. subsidiaries are on a fiscal year ending November 30, and this tax liability will not become a fixed obligation until November 30,

2018. The estimated impact of the Tax Act is based on a preliminary review of the new law and projected future financial results and is subject to revision based upon further analysis and interpretation of the Tax Act and to the extent that future results differ from currently available projections. However, on the basis of revised computations that were calculated during the reporting period, we recognized a measurement-period adjustment of $33 million and $35 million for the three and six months ended June 30, 2018, respectively, as a decrease to the one-time mandatory deemed repatriation tax obligation, with a corresponding adjustment to income tax benefit during the period. The effect of the measurement-period adjustment to the three and six months ended June 30, 2018 effective tax rate was a reduction to the rate of approximately 7.5% and 4.1%, respectively. In addition, we reclassified the one-time mandatory deemed repatriation tax from Noncurrent deferred tax liabilities to Income taxes payable and Other taxes payable. We expect to complete our accounting within the prescribed measurement period.

- Reduction of U.S. Federal Corporate Tax Rate: The Tax Act reduced the corporate tax rate to 21%, effective January 1, 2018. Consequently, we recorded a decrease related to deferred tax assets and liabilities with a corresponding net adjustment to deferred income tax benefit for the year ended December 31, 2017. We have not made any measurement-period adjustments related to this item during the first half of 2018. Since the company has recorded provisional amounts related to certain portions of the Tax Act, any corresponding deferred tax remeasurement is also provisional. However, we are continuing to gather additional information to complete our accounting for this item and expect to be completed within the prescribed measurement period.

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- Valuation Allowances: The company must assess whether its valuation allowance analyses are affected by the various aspects of the Tax Act (e.g., one-time mandatory deemed repatriation of deferred foreign income, global intangible low-taxed income inclusions, and new categories of foreign tax credits). We have not made any measurement-period adjustments related to this item during the first half of 2018. Since the company has recorded provisional amounts related to certain portions of the Tax Act, any corresponding determination of the need for or change in a valuation allowance is also provisional. However, we are continuing to gather additional information to complete our accounting for this item and expect to be completed within the prescribed measurement period.
- Global Intangible Low-Taxed Income (GILTI) Policy Election: The GILTI provisions of the Tax Act do not apply to the company until 2019, due to the fact that the non-U.S. subsidiaries are on a fiscal year ending November 30, and we are still evaluating its impact. The FASB allows companies to adopt an accounting policy to either recognize deferred taxes for GILTI or treat such tax cost as a current-period expense when incurred. We have not yet determined our accounting policy because determining the impact of the GILTI provisions requires analysis of our existing legal entity structure, the reversal of our U.S. GAAP and U.S. tax basis differences in the assets and liabilities of our foreign subsidiaries, and our ability to offset any tax with foreign tax credits. As such, we have not made a policy decision whether to record deferred taxes on GILTI or treat such tax cost as a current-period expense.

The effective tax rate was 12.6% for the three months ended June 30, 2018, compared with 28.4% for the three months ended July 2, 2017. The lower effective tax rate for the three months ended June 30, 2018, was primarily attributable to:

- the reduction of the U.S. federal corporate income tax rate from 35% to 21%, effective January 1, 2018, pursuant to the Tax Act;
- a $33 million net discrete tax benefit recorded in the second quarter of 2018, associated with a measurement-period adjustment related to the provisional one-time mandatory deemed repatriation tax on the company's undistributed non-U.S. earnings pursuant to the Tax Act enacted on December 22, 2017;
- 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; and
- a $1 million and $2 million discrete tax benefit recorded in the second quarter of 2018 and 2017, respectively, related to the excess tax benefits for share-based payments.

The effective tax rate was 14.3% for the six months ended June 30, 2018, compared with 28.7% for the six months ended July 2, 2017. The lower effective tax rate for the six months ended June 30, 2018, was primarily attributable to:

- the reduction of the U.S. federal corporate income tax rate from 35% to 21%, effective January 1, 2018, pursuant to the Tax Act;
- a $35 million net discrete tax benefit recorded in the first half of 2018, associated with a measurement-period adjustment related to the provisional one-time mandatory deemed repatriation tax on the company's undistributed non-U.S. earnings pursuant to the Tax Act enacted on December 22, 2017;
- 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;
- an $8 million and $7 million discrete tax benefit recorded in the first half of 2018 and 2017, respectively, related to the excess tax benefits for share-based payments; and
- an $8 million and $3 million discrete tax benefit recorded in the first half of 2018 and 2017, respectively, related to a remeasurement of deferred taxes as a result of a change in non-U.S. statutory tax rates.

B. Deferred Taxes

As of June 30, 2018, the total net deferred income tax liability of $149 million is included in Noncurrent deferred tax assets ($80 million) and Noncurrent deferred tax liabilities ($229 million).

As of December 31, 2017, the total net deferred income tax liability of $300 million is included in Noncurrent deferred tax assets ($80 million) and Noncurrent deferred tax liabilities ($380 million).

The change in Noncurrent deferred tax liabilities was primarily due to the reclassification of the one-time mandatory deemed repatriation tax from Noncurrent deferred tax liabilities to Income taxes payable and Other taxes payable to

properly reflect the liability, which became a fixed obligation in 2018, payable over eight years.

C. Tax Contingencies

As of June 30, 2018, the tax liabilities associated with uncertain tax positions of $182 million (exclusive of interest and penalties related to uncertain tax positions of $11 million) are included in Noncurrent deferred tax assets ($4 million) and Other taxes payable ($178 million).

As of December 31, 2017, the tax liabilities associated with uncertain tax positions of $164 million (exclusive of interest and penalties related to uncertain tax positions of $11 million) are included in Noncurrent deferred tax assets ($3 million) and Other taxes payable ($161 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

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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.

9. 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). In December 2017, the maturity for the amended and restated revolving credit agreement was extended through December 2022. 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 June 30, 2018, and December 31, 2017. There were no amounts drawn under the credit facility as of June 30, 2018, or December 31, 2017.

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 June 30, 2018, we had access to $61 million of lines of credit which expire at various times throughout 2018 and 2019 and are generally renewed annually. We did not have any borrowings outstanding related to these facilities as of June 30, 2018, and December 31, 2017.

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 June 30, 2018, and December 31, 2017, there was no commercial paper outstanding under this program. As of June 30, 2018, and December 31, 2017, we did not have any other short-term borrowings outstanding.

Senior Notes and Other Long-Term Debt

On September 12, 2017, we issued $1.25 billion aggregate principal amount of our senior notes (2017 senior notes), with an original issue discount of $7 million. These notes are comprised of $750 million aggregate principal amount of 3.000% senior notes due 2027 and $500 million aggregate principal amount of 3.950% senior notes due 2047. Net proceeds from this offering were partially used in October 2017 to repay, prior to maturity, the aggregate principal amount of $750 million, and a make-whole amount and accrued interest of $4 million, of our 1.875% senior notes due 2018. The remainder of the net proceeds will be used for general corporate purposes.

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, 2015 and 2017 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, 2015 and 2017 senior notes may be declared immediately due and payable.

Pursuant to the indenture, we are able to redeem the 2013, 2015 and 2017 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, 2015 and 2017 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, 2015 and 2017 senior notes at a price equal to 101% of the aggregate principal amount of the 2013, 2015 and 2017 senior notes together with accrued and unpaid interest to, but excluding, the date of repurchase.

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

(MILLIONS OF DOLLARS)	June 30, 2018	December 31, 2017
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
3.000% 2017 senior notes due 2027	750	750
4.700% 2013 senior notes due 2043	1,150	1,150
3.950% 2017 senior notes due 2047	500	500
	5,000	5,000
Unamortized debt discount / debt issuance costs	(45)	(47)
Long-term debt, net of discount and issuance costs	$4,955	$ 4,953

The fair value of our long-term debt was $4,994 million and $5,291 million as of June 30, 2018, and December 31, 2017, 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 June 30, 2018, matures in the following years:

(MILLIONS OF DOLLARS)	2019	2020	2021	2022	After 2022	Total
Maturities	$ —	$500	$ —	$ —	$4,500	$5,000

Interest Expense

Interest expense, net of capitalized interest, was $46 million and $93 million, for the three and six months ended June 30, 2018, respectively, and $41 million and $82 million, for the three and six months ended July 2, 2017, respectively. Capitalized interest expense was $2 million and $4 million for the three and six months ended June 30, 2018, respectively, and $1 million and $2 million for the three and six months ended July 2, 2017, 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 various derivative financial instruments. These derivative financial instruments serve to manage the exposure of our net investment in certain foreign operations to changes in foreign exchange rates and protect net income against the impact of translation into U.S. dollars of certain foreign exchange-denominated transactions.

All derivative financial instruments 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 derivative financial instruments primarily offset exposures in the Australian dollar, Brazilian real, British pound, Canadian dollar, Chinese renminbi, euro, and Norwegian krone. Changes in fair value are reported in earnings or in Accumulated other comprehensive income/(loss), depending on the nature and purpose of the financial instrument, as follows:

- For foreign exchange contracts not designated 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.
- For cross-currency interest rate swaps, which are designated as a hedge against our net investment in foreign operations, changes in the fair value are deferred as a component of cumulative translation adjustment within Accumulated other comprehensive loss and reclassified into earnings when the foreign investment is sold or substantially liquidated. Gains and losses excluded from the assessment of hedge effectiveness are recognized in earnings (Interest expense—net of capitalized interest). The impact of the periodic exchange of interest payments is

reflected within the operating section of our condensed consolidated statement of cash flows.

The aggregate notional amount of foreign exchange derivative financial instruments offsetting foreign currency exposures was $1.3 billion and $1.4 billion, as of June 30, 2018, and December 31, 2017, respectively. The vast majority of the foreign exchange derivative financial instruments mature within 60 days and all mature within 270 days. The aggregate notional amount of cross-currency interest rate swap contracts was 225 million euro as of June 30, 2018, with a term of up to seven years. We did not have any cross-currency interest rate swap contracts as of December 31, 2017.

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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. Unrealized gains or losses on the forward-starting interest rate swaps are reported in Accumulated other comprehensive loss and are recognized in earnings 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 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. There were no outstanding interest rate swap contracts as of both June 30, 2018, and December 31, 2017.

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	June 30, 2018	December 31, 2017
Derivatives Not Designated as Hedging Instruments			
Foreign currency forward-exchange contracts	Other current assets	$ 20	$ 10
Foreign currency forward-exchange contracts	Other current liabilities	(8)	(9)
Total derivatives not designated as hedging instruments		$ 12	$ 1
Derivatives Designated as Hedging Instruments:			
Cross-currency interest rate swap contracts	Other non-current assets	$ 1	$ —
Total derivatives designated as hedging instruments		1	—
Total derivatives		$ 13	$ 1

The company's cross-currency interest rate swaps are subject to master netting arrangements to mitigate credit risk by permitting net settlement of transactions with the same counterparty. We may also enter into collateral security arrangements with certain of our counterparties to exchange cash collateral when the net fair value of certain derivative instruments fluctuates from contractually established thresholds. At June 30, 2018, there was no collateral posted related to our derivatives.

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)	June 30, 2018	July 2, 2017	June 30, 2018	July 2, 2017
Foreign currency forward-exchange contracts	$ 10	$ 7	$ —	$ (22)

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 gains/(losses) on cross-currency interest rate swap contracts, recorded, net of tax, in Accumulated other comprehensive income/(loss), are as follows:

(MILLIONS OF DOLLARS)	Three Months Ended June 30, 2018	Three Months Ended July 2, 2017	Six Months Ended June 30, 2018	Six Months Ended July 2, 2017
Cross-currency interest rate swap contracts	$ 1	$ —	$ 1	$ —

Gains/(losses) on cross-currency interest rate swap contracts, recognized within Interest expense, net of capitalized interest, are as follows;

(MILLIONS OF DOLLARS)	Three Months Ended June 30, 2018	Three Months Ended July 2, 2017	Six Months Ended June 30, 2018	Six Months Ended July 2, 2017
Cross-currency interest rate swap contracts	$ 1	$ —	$ 1	$ —

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The net amount of deferred gains/(losses) related to derivative instruments designated as cash flow hedges that is expected to be reclassified from Accumulated other comprehensive loss into earnings over the next 12 months is insignificant.

10. Inventories

The components of inventory are as follows:

(MILLIONS OF DOLLARS)	June 30, 2018	December 31, 2017
Finished goods	$768	$ 788
Work-in-process	492	484
Raw materials and supplies	160	155
Inventories	$1,420	$ 1,427

11. 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, 2017	$671	$ 839	$1,510
Other[a]	—	4	4
Balance, June 30, 2018	$671	$ 843	$1,514

[a] Includes adjustments for foreign currency translation.

The gross goodwill balance was $2,050 million and $2,046 million as of June 30, 2018, and December 31, 2017, respectively. Accumulated goodwill impairment losses were $536 million as of June 30, 2018, and December 31, 2017.

B. Other Intangible Assets

The components of identifiable intangible assets are as follows:

	As of June 30, 2018			As of December 31, 2017		
(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	$1,187	$ (465)	$ 722	$1,185	$ (428)	$ 757
Brands	213	(149)	64	213	(143)	70
Trademarks and trade names	62	(48)	14	62	(47)	15
Other	237	(147)	90	234	(143)	91
Total finite-lived intangible assets	1,699	(809)	890	1,694	(761)	933
Indefinite-lived intangible assets:						
Brands	37	—	37	37	—	37
Trademarks and trade names	67	—	67	67	—	67
In-process research and development	224	—	224	224	—	224
Product rights	7	—	7	8	—	8
Total indefinite-lived intangible assets	335	—	335	336	—	336
Identifiable intangible assets	$2,034	$ (809)	$ 1,225	$2,030	$ (761)	$ 1,269

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 $26 million and $51 million for each of the three and six months ended June 30, 2018, respectively, and $24 million and $49 million for each of the three and six months ended July 2, 2017.

12. 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 continued to credit certain employees' service with Zoetis 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 June 30, 2018, and July 2, 2017, and $3 million for each of the six month periods ended June 30, 2018, and July 2, 2017.

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)	June 30, 2018	July 2, 2017	June 30, 2018	July 2, 2017
Service cost	$ 2	$ 1	$4	$ 3
Interest cost	—	—	1	1
Expected return on plan assets	—	—	(1)	(1)

Amortization of net actuarial loss	—	1	—	1
Curtailment and settlement loss	—	—	—	1
Net periodic benefit cost	$ 2	$ 2	$4	$ 5

Total company contributions to the international pension plans were $1 million and $3 million for the three and six months ended June 30, 2018, respectively, and $1 million and $4 million for the three and six months ended July 2, 2017, respectively. We expect to contribute a total of approximately $6 million to these plans in 2018.

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13. 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)	June 30, 2018	July 2, 2017	June 30, 2018	July 2, 2017
Stock options / stock appreciation rights	$3	$2	$5	$5
RSUs / DSUs	6	7	13	13
PSUs	2	2	4	4
Share-based compensation expense—total[(a)]	$11	$11	$22	$22

(a) For the three and six months ended June 30, 2018, and July 2, 2017, amounts capitalized to inventory were insignificant.

During the six months ended June 30, 2018, the company granted 538,820 stock options with a weighted-average exercise price of $73.32 per stock option and a weighted-average fair value of $20.30 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 2.74%; expected dividend yield of 0.69%; expected stock price volatility of 23.61%; 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 June 30, 2018, the company granted 431,615 RSUs with a weighted-average grant date fair value of $73.31 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 June 30, 2018, the company granted 109,574 PSUs with a weighted-average grant date fair value of $100.34 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 21.9% and 25.1%, 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.

14. Stockholders' Equity

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

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. As of June 30, 2018, there was approximately $595 million remaining under this authorization.

Changes in common shares and treasury stock were as follows:

(MILLIONS)	Common Shares Issued[a]	Treasury Stock[a]
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
Balance, December 31, 2017	501.89	15.76
Share-based compensation[b]	—	(1.11)
Share repurchase program	—	4.95
Balance, June 30, 2018	501.89	19.60

[a] Shares may not add due to rounding.

[b] Includes the reissuance of shares from treasury stock in connection with the vesting of employee share-based awards, and 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 13. Share-Based Payments.

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

	Derivatives	Currency Translation Adjustment	Benefit Plans	Accumulated Other
(MILLIONS OF DOLLARS)	Net Unrealized Gains/(Losses)	Net Unrealized Gains/(Losses)	Actuarial Gains/(Losses)	Comprehensive Loss
Balance, December 31, 2016	$ 8	$ (583)	$ (23)	$ (598)
Other comprehensive (loss)/income, net of tax	(1)	56	1	56
Balance, July 2, 2017	$ 7	$ (527)	$ (22)	$ (542)
Balance, December 31, 2017	$ (3)	$ (487)	$ (15)	$ (505)
Other comprehensive loss, net of tax	—	(38)	—	(38)
Balance, June 30, 2018	$ (3)	$ (525)	$ (15)	$ (543)

15. 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)	June 30, 2018	July 2, 2017	June 30, 2018	July 2, 2017
Numerator				
Net income before allocation to noncontrolling interests	$382	$247	$732	$486
Less: Net (loss)/income attributable to noncontrolling interests	(2)	—	(4)	1
Net income attributable to Zoetis Inc.	$384	$247	$736	$485
Denominator				
Weighted-average common shares outstanding	483.8	490.8	484.8	491.6
Common stock equivalents: stock options, RSUs, PSUs and DSUs	3.7	3.2	3.8	3.0
Weighted-average common and potential dilutive shares outstanding	487.5	494.0	488.6	494.6
Earnings per share attributable to Zoetis Inc. stockholders—basic	$0.79	$0.50	$1.52	$0.99
Earnings per share attributable to Zoetis Inc. stockholders—diluted	$0.79	$0.50	$1.51	$0.98

The number of stock options outstanding under the company's Equity Plan that were excluded from the computation of diluted earnings per share, as the effect would have been antidilutive, were de minimis for the six months ended June 30, 2018, and approximately 1 million for the three months ended June 30, 2018, and each of the three and six months ended July 2, 2017.

16. 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 8. 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.

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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 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.

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 and the prosecutor agreed to engage the services of a third-party consultant to conduct a limited environmental assessment of the site. The site assessment was conducted during June 2017, and a written report summarizing the results of the assessment was provided to the parties and the prosecutor in November 2017. The report noted that waste is still present on the site and that further environmental assessments are needed before a plan to manage that remaining waste can be prepared. We have not received any further communication from the prosecutor in response to the report.

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

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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, 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. On July 28, 2017, we filed a motion for summary disposition on the grounds that no genuine issues of material fact exist and that Zoetis is entitled to judgment as a matter of law. On October 19, 2017, the Court granted our motion and dismissed all claims against Zoetis. On October 31, 2017, the plaintiffs filed motions for reconsideration of the Court's decision granting summary disposition. The Court, denied all such motions on December 6, 2017, for the same reasons cited in the Court’s original decision. On December 27, 2017, the plaintiffs filed a request with the Michigan Court of Appeals seeking an appeal of the lower Court’s decision, which we opposed on January 17, 2018. On July 5, 2018, the Court of Appeals denied the plaintiffs’ applications for leave to appeal. The case has been remanded to the lower Court, where it will proceed without Zoetis. The plaintiffs may attempt to seek a full appeal after the final adjudication of the case before the lower Court.

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 companies is Alpharma LLC, a legal entity that was transferred to Zoetis as part of the separation from Pfizer. Alpharma LLC's involvement is solely related to certain discontinued human health activities that occurred prior to Pfizer's acquisition of King/Alpharma. As a result of the decision, a fine in the amount of euro 11 million (approximately $14 million) was imposed on 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, meaning that Pfizer ultimately bears the costs of the penalties in connection with the Commission's decision. Working with Pfizer, we filed an appeal of the decision on September 6, 2013, to the General Court of the European Union, and on September 17, 2013, Pfizer released payment of euro 11 million to the Commission to cover the fine. 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 June 30, 2018, recorded amounts for the estimated fair value of these indemnifications were not significant.

17. 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.

In the first quarter of 2018, the company realigned certain management responsibilities. These changes did not impact the determination of our operating segments, however they resulted in the reallocation of certain costs between segments. These changes primarily include the following: (i) R&D costs related to our aquaculture business which were previously reported in Other business activities are now reported in the international commercial segment results, and (ii) certain other miscellaneous costs which were previously reported in Corporate are now reported in the international commercial segment results.

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 our aquaculture business and 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

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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.

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Selected Statement of Income Information

	Earnings		Depreciation and Amortization[a]	
	Three Months Ended		Three Months Ended	
(MILLIONS OF DOLLARS)	June 30, 2018	July 2, 2017	June 30, 2018	July 2, 2017
U.S.				
Revenue	$677	$623		
Cost of sales	140	134		
Gross profit	537	489		
Gross margin	79.3 %	78.5 %		
Operating expenses	116	113		
Other (income)/deductions	—	—		
U.S. Earnings	421	376	$ 8	$ 7
International				
Revenue[b]	728	634		
Cost of sales	229	219		
Gross profit	499	415		
Gross margin	68.5 %	65.5 %		
Operating expenses	147	126		
Other (income)/deductions	2	2		
International Earnings	350	287	12	11
Total operating segments	771	663	20	18
Other business activities	(82)	(73)	6	6
Reconciling Items:				
Corporate	(139)	(151)	14	13
Purchase accounting adjustments	(23)	(21)	22	21
Acquisition-related costs	—	(2)	—	—
Certain significant items[c]	(7)	1	—	—
Other unallocated	(83)	(72)	1	1
Total Earnings[d]	$437	$345	$ 63	$ 59

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	Earnings		Depreciation and Amortization[a]	
	Six months ended		Six months ended	
(MILLIONS OF DOLLARS)	June 30, 2018	July 2, 2017	June 30, 2018	July 2, 2017
U.S.				
Revenue	$1,311	$1,228		
Cost of sales	280	271		
Gross profit	1,031	957		
Gross margin	78.6 %	77.9 %		
Operating expenses	212	209		
Other (income)/deductions	—	—		
U.S. Earnings	819	748	$ 16	$ 14
International				
Revenue[b]	1,454	1,249		
Cost of sales	463	432		
Gross profit	991	817		
Gross margin	68.2 %	65.4 %		
Operating expenses	280	240		
Other (income)/deductions	3	(1)		
International Earnings	708	578	23	22
Total operating segments	1,527	1,326	39	36
Other business activities	(163)	(147)	11	12
Reconciling Items:				
Corporate	(292)	(294)	27	25
Purchase accounting adjustments	(46)	(43)	45	43
Acquisition-related costs	(1)	(2)	—	—
Certain significant items[c]	(10)	(3)	—	2
Other unallocated	(161)	(155)	1	3
Total Earnings[d]	$854	$682	$ 123	$ 121

(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 $191 million and $375 million for the three and six months ended June 30, 2018, respectively, and $155 million and $303 million for the three and six months ended July 2, 2017, respectively.

(c) For the three months ended June 30, 2018, Certain significant items primarily includes: (i) employee termination costs of $1 million, related to our operational efficiency initiative, (ii) consulting fees of $2 million, and exit costs of $1 million, related to our supply network strategy, and (iii) employee termination costs of $3 million in Europe as a result of initiatives to better align our organizational structure.

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 six months ended June 30, 2018, Certain significant items primarily includes: (i) employee termination costs of $1 million, related to our operational efficiency initiative, (ii) consulting fees of $3 million, employee termination costs of $1 million, and exit costs of $1 million, related to our supply network strategy, (iii) employee termination costs of $3 million in Europe as a result of initiatives to better align our organizational structure, and (iv) a charge of $1 million related to the implementation of new accounting guidance as a result of the enactment of the Tax Act.

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.

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

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18. Subsequent Events

Credit Facilities and Commercial Paper Program

On July 27, 2018, we entered into a new revolving credit agreement (the Credit Agreement) with a syndicate of banks, providing for a 364-day $500 million senior unsecured revolving credit facility. Subject to certain conditions, we will have the right to, as of the date on which the revolving credit facility would otherwise terminate, convert all or a portion of outstanding revolving loans under the Credit Agreement into term loans with a one-year maturity. Additionally, the Credit Agreement requires us to prepay any borrowings thereunder with the net cash proceeds of any issuance of senior unsecured notes by us or any of our subsidiaries. The Credit Agreement contains financial covenants requiring us to not exceed a maximum total leverage ratio of 3.50:1 and to maintain a minimum interest coverage ratio of 3.50:1. In addition, the Credit Agreement contains other customary covenants.

In July 2018, in anticipation of the closing of the previously-announced acquisition of Abaxis, Inc., in order to finance a portion of the cash consideration for the acquisition, we borrowed funds of $500 million under the Credit Agreement and issued commercial paper of $500 million under our existing commercial paper program.

Acquisition of Abaxis, Inc.

On July 31, 2018, we completed the acquisition of Abaxis, Inc., a California corporation, a leader in the development, manufacture and marketing of diagnostic instruments for veterinary point-of-care services, for $83 per share in cash, or approximately $2 billion in aggregate. The acquisition enhances our presence in veterinary diagnostics. The final allocation of the purchase price amongst assets, liabilities and goodwill is subject to final valuation.

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Report of Independent Registered Public Accounting Firm
To the Stockholders and Board of Directors
Zoetis, Inc.:
Results of Review of Interim Financial Information

We have reviewed the condensed consolidated balance sheet of Zoetis, Inc. and subsidiaries (the Company) as of June 30, 2018, the related condensed consolidated statements of income, comprehensive income, for the three-month and six-month periods ended June 30, 2018 and July 2, 2017, the related condensed consolidated statements of equity and cash flows for the six-month periods ended June 30, 2018 and July 2, 2017, and the related notes (collectively, the consolidated interim financial information). Based on our reviews, we are not aware of any material modifications that should be made to the consolidated interim financial information for it to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheet of the Company as of December 31, 2017, 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 15, 2018, 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, 2017, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Basis for Review Results

This consolidated interim financial information is the responsibility of the Company’s management. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our reviews in accordance with the standards of the PCAOB. A review of consolidated 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 PCAOB, 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.

/s/ KPMG LLP
Short Hills, New Jersey
August 2, 2018

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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 17. Segment 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 one of the largest animal health medicines and vaccines businesses 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 one of the industry's largest sales organizations, 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, have 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 2018 performance compared with the comparable 2017 period follows:

			% Change		
	Three Months Ended			Related to	
(MILLIONS OF DOLLARS)	June 30, 2018	July 2, 2017	Total	Foreign Exchange	Operational[(a)]
Revenue	$1,415	$1,269	12	3	9
Net income attributable to Zoetis	384	247	55	7	48
Adjusted net income[(a)]	375	261	44	7	37

			% Change		
	Six Months Ended			Related to	
(MILLIONS OF DOLLARS)	June 30, 2018	July 2, 2017	Total	Foreign Exchange	Operational[(a)]
Revenue	$2,781	$2,500	11	3	8
Net income attributable to Zoetis	736	485	52	8	44
Adjusted net income[(a)]	740	522	42	6	36

(a) Operational growth and adjusted net income are non-GAAP financial measures. See the Non-GAAP financial measures 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 2017 Annual Report on Form 10-K. Set forth below are updates to certain of the factors disclosed in our 2017 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. At the same time, sales of products that treat specific disease outbreaks may increase.

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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 June 30, 2018, approximately 50% 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, Chinese yuan, 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 June 30, 2018, approximately 50% of our total revenue was in U.S. dollars. Our year-over-year revenue growth was favorably impacted by approximately 3% from changes in foreign currency values relative to the U.S. dollar.

Non-GAAP financial measures

We report information in accordance with U.S. generally accepted accounting principles (GAAP). Management also measures performance using non-GAAP financial measures that may exclude certain amounts from the most directly comparable GAAP measure. Despite the importance of these measures to management in goal setting and performance measurement, non-GAAP financial measures have no standardized meaning prescribed by U.S. GAAP and, therefore, have limits in their usefulness to investors and may not be comparable to the calculation of similar measures of other companies. We present certain identified non-GAAP measures solely to provide investors with useful information to more fully understand how management assesses performance.

Operational Growth

We believe that it is important to not only understand overall revenue and earnings growth, but also “operational growth.” Operational growth is a non-GAAP financial measure defined as revenue or earnings growth excluding the impact of foreign exchange. This measure provides information on the change in revenue and earnings as if foreign currency exchange rates had not changed between the current and prior periods to facilitate a period-to-period comparison. We believe this non-GAAP measure provides a useful comparison to previous periods for the company and investors, but should not be viewed as a substitute for U.S. GAAP reported growth.

Adjusted Net Income and Adjusted Earnings Per Share

Adjusted net income and the corresponding adjusted earnings per share (EPS) are non-GAAP financial measures of performance used by management. We believe these financial measures are useful supplemental information to investors when considered together with our U.S. GAAP financial measures. We report adjusted net income to portray the results of our major operations, and the discovery, development, manufacture and commercialization of our products, prior to considering certain income statement elements. We define adjusted net income and adjusted EPS as net income attributable to Zoetis and EPS before the impact of purchase accounting adjustments, acquisition-related costs and certain significant items.

We recognize that, as an internal measure of performance, the adjusted net income and adjusted EPS measures have limitations, and we do not restrict our performance management process solely to these metrics. A limitation of the adjusted net income and adjusted EPS measures is that they provide 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 do not provide a comparable view of our performance to other companies. The adjusted net income and adjusted EPS measures are not, and should not be viewed as, a substitute for U.S. GAAP reported net income attributable to Zoetis and reported EPS. See the Adjusted Net Income section below for more information.

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)	June 30, 2018	July 2, 2017	% Change	June 30, 2018	July 2, 2017	% Change
Revenue	$1,415	$1,269	12	$2,781	$2,500	11
Costs and expenses:						
Cost of sales[a]	447	440	2	894	883	1
% of revenue	31.6 %	34.7 %		32.1 %	35.3 %	
Selling, general and administrative expenses[a]	359	336	7	697	645	8
% of revenue	25 %	26 %		25 %	26 %	
Research and development expenses[a]	102	86	19	199	176	13
% of revenue	7 %	7 %		7 %	7 %	
Amortization of intangible assets[a]	23	23	—	46	45	2
Restructuring charges/(reversals) and certain acquisition-related costs	5	—	*	7	(1)	*
Interest expense, net of capitalized interest	46	41	12	93	82	13
Other (income)/deductions—net	(4)	(2)	100	(9)	(12)	(25)
Income before provision for taxes on income	437	345	27	854	682	25
% of revenue	31 %	27 %		31 %	27 %	
Provision for taxes on income	55	98	(44)	122	196	(38)
Effective tax rate	12.6 %	28.4 %		14.3 %	28.7 %	
Net income before allocation to noncontrolling interests	382	247	55	732	486	51
Less: Net income attributable to noncontrolling interests	(2)	—	—	(4)	1	*
Net income attributable to Zoetis	$384	$247	55	$736	$485	52
% of revenue	27 %	19 %		26 %	19 %	

* 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 June 30, 2018 vs. three months ended July 2, 2017

Total revenue increased by $146 million, or 12%, in the three months ended June 30, 2018, compared with the three months ended July 2, 2017, an increase of $116 million, or 9%, on an operational basis. Operational revenue growth was comprised primarily of the following:

- increased volume from in-line products of approximately 5%, including 2% from our key dermatology products;
- volume growth from new products of approximately 3%; and
- price growth of approximately 1%.

Foreign exchange increased reported revenue growth by approximately 3%.

Six months ended June 30, 2018 vs. six months ended July 2, 2017

Total revenue increased by $281 million, or 11%, in the six months ended June 30, 2018, compared with the six months ended July 2, 2017, an increase of $204 million, or 8%, on an operational basis. Operational revenue growth was comprised primarily of the following:

- increased volume from in-line products of approximately 5%, including 3% from our key dermatology products;
- volume growth from new products of approximately 2%; and
- price growth of approximately 1%.

Foreign exchange increased reported revenue growth by approximately 3%.

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Costs and Expenses

Cost of sales

(MILLIONS OF DOLLARS)	Three Months Ended June 30, 2018	July 2, 2017	% Change	Six Months Ended June 30, 2018	July 2, 2017	% Change
Cost of sales	$447	$440	2	$894	$883	1
% of revenue	31.6 %	34.7 %		32.1 %	35.3 %	

Certain amounts and percentages may reflect rounding adjustments.

Three months ended June 30, 2018 vs. three months ended July 2, 2017

Cost of sales as a percentage of revenue decreased from 34.7% to 31.6% in the three months ended June 30, 2018, compared with the three months ended July 2, 2017, primarily as a result of:

- continued cost improvements and efficiencies in our manufacturing network; and
- favorable foreign exchange.

Six months ended June 30, 2018 vs. six months ended July 2, 2017

Cost of sales as a percentage of revenue decreased from 35.3% to 32.1% in the six months ended June 30, 2018, compared with the six months ended July 2, 2017, primarily as a result of:

- continued cost improvements and efficiencies in our manufacturing network; and
- favorable foreign exchange.

Selling, general and administrative expenses

(MILLIONS OF DOLLARS)	Three Months Ended June 30, 2018	July 2, 2017	% Change	Six Months Ended June 30, 2018	July 2, 2017	% Change
Selling, general and administrative expenses	$359	$336	7	$697	$645	8
% of revenue	25 %	26 %		25 %	26 %	

Certain amounts and percentages may reflect rounding adjustments.

Three months ended June 30, 2018 vs. three months ended July 2, 2017

Selling, general & administrative (SG&A) expenses increased by $23 million, or 7%, in the three months ended June 30, 2018, compared with the three months ended July 2, 2017, primarily as a result of:

- an increase in certain compensation-related expenses;
- unfavorable foreign exchange; and
- higher distribution expenses associated with higher sales volumes.

Six months ended June 30, 2018 vs. six months ended July 2, 2017

Selling, general & administrative (SG&A) expenses increased by $52 million, or 8%, in the six months ended June 30, 2018, compared with the six months ended July 2, 2017, primarily as a result of:

- an increase in certain compensation-related expenses;
- unfavorable foreign exchange;
- higher professional services and consulting charges;
- higher advertising and promotional spending associated with new products; and
- higher distribution expenses associated with higher sales volumes.

Research and development expenses

	Three Months Ended June 30,	July 2,	%	Six Months Ended June 30,	July 2,	%

(MILLIONS OF DOLLARS)	2018	2017	Change	2018	2017	Change
Research and development expenses	$102	$86	19	$199	$176	13
% of revenue	7 %	7 %		7 %	7 %	

Certain amounts and percentages may reflect rounding adjustments.

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Three months ended June 30, 2018 vs. three months ended July 2, 2017

R&D expenses increased by $16 million, or 19%, in the three months ended June 30, 2018, compared with the three months ended July 2, 2017, primarily as a result of:

- increased headcount and other spending driven by project investments;
- unfavorable foreign exchange;
- an increase in certain compensation-related expenses; and
- the inclusion of the Irish biologic therapeutics business acquired in 2017.

Six months ended June 30, 2018 vs. six months ended July 2, 2017

R&D expenses increased by $23 million, or 13%, in the six months ended June 30, 2018, compared with the six months ended July 2, 2017, primarily as a result of:

- increased headcount driven by project investments;
- unfavorable foreign exchange;
- an increase in certain compensation-related expenses; and
- the inclusion of the Irish biologic therapeutics business acquired in 2017.

Amortization of intangible assets

(MILLIONS OF DOLLARS)	Three Months Ended June 30, 2018	July 2, 2017	% Change	Six Months Ended June 30, 2018	July 2, 2017	% Change
Amortization of intangible assets	$23	$ 23	—	$46	$ 45	2

Certain amounts and percentages may reflect rounding adjustments.

Three months ended June 30, 2018 vs. three months ended July 2, 2017

Amortization of intangible assets was flat in the three months ended June 30, 2018, compared with the three months ended July 2, 2017.

Six months ended June 30, 2018 vs. six months ended July 2, 2017

Amortization of intangible assets increased by $1 million, or 2%, in the six months ended June 30, 2018, compared with the six months ended July 2, 2017.

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

(MILLIONS OF DOLLARS)	Three Months Ended June 30, 2018	July 2, 2017	% Change	Six Months Ended June 30, 2018	July 2, 2017	% Change
Restructuring charges/(reversals) and certain acquisition-related costs	$ 5	$ —	*	$7	$ (1)	*

* Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

During 2015, we launched a comprehensive operational efficiency program, which was incremental to the previously announced supply network strategy. These initiatives focused on reducing complexity in our product portfolios, changing our selling approach in certain markets, reducing our presence in certain countries, and exiting manufacturing sites over a long term period. We have also continued 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. The comprehensive operational efficiency program was substantially completed as of December 31, 2017. We expect to complete the 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 these net restructuring charges are related to

termination costs, but we also exited a number of distributor and other contracts and performed certain 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 6. Restructuring Charges and Other Costs Associated with Acquisitions and Cost-Reduction/Productivity Initiatives.

Three months ended June 30, 2018 vs. three months ended July 2, 2017

The change in restructuring charges and certain acquisition-related costs from $0 million in the three months ended July 2, 2017, to $5 million in the three months ended June 30, 2018, is primarily due to charges in the three months ended June 30, 2018, related to employee termination costs in Europe as a result of initiatives to better align our organizational structure, employee termination costs and exit costs as a result of our operational efficiency initiative and supply network strategy, and integration costs.

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Six months ended June 30, 2018 vs. six months ended July 2, 2017

The change in restructuring charges and certain acquisition-related costs from a $1 million reversal in the six months ended July 2, 2017, to $7 million in the six months ended June 30, 2018, is primarily due to charges in the six months ended June 30, 2018, related to employee termination costs in Europe as a result of initiatives to better align our organizational structure, employee termination costs and exit costs as a result of our operational efficiency initiative and supply network strategy, and an increase in integration costs.

Interest expense, net of capitalized interest

	Three Months Ended			Six Months Ended		
(MILLIONS OF DOLLARS)	June 30, 2018	July 2, 2017	% Change	June 30, 2018	July 2, 2017	% Change
Interest expense, net of capitalized interest	$46	$ 41	12	$93	$ 82	13

Certain amounts and percentages may reflect rounding adjustments.

Three months ended June 30, 2018 vs. three months ended July 2, 2017

Interest expense, net of capitalized interest, increased by $5 million, or 12% in the three months ended June 30, 2018, compared with the three months ended July 2, 2017, as a result of the issuance of $1.25 billion aggregate principal amount of our senior notes in September 2017.

Six months ended June 30, 2018 vs. six months ended July 2, 2017

Interest expense, net of capitalized interest, increased by $11 million, or 13% in the six months ended June 30, 2018, compared with the six months ended July 2, 2017, as a result of the issuance of $1.25 billion aggregate principal amount of our senior notes in September 2017.

Other (income)/deductions—net

	Three Months Ended			Six Months Ended		
(MILLIONS OF DOLLARS)	June 30, 2018	July 2, 2017	% Change	June 30, 2018	July 2, 2017	% Change
Other (income)/deductions—net	$(4)	$(2)	100	$(9)	$(12)	(25)

Certain amounts and percentages may reflect rounding adjustments.

Three months ended June 30, 2018 vs. three months ended July 2, 2017

The change in Other (income)/deductions—net from income of $2 million in the three months ended July 2, 2017, to income of $4 million in the three months ended June 30, 2018, is primarily a result of:

- higher interest income in the three months ended June 30, 2018 due to higher cash balances, and
- a net loss of $2 million in the three months ended July 2, 2017, related to divestitures as part of our operational efficiency initiative,

partially offset by:

- income of $4 million in the three months ended July 2, 2017, related to an insurance recovery from commercial settlements in Mexico recorded in 2014 and 2016.

Six months ended June 30, 2018 vs. six months ended July 2, 2017

The change in Other (income)/deductions—net from income of $12 million in the six months ended July 2, 2017, to income of $9 million in the six months ended June 30, 2018, is primarily a result of:

- higher foreign currency losses in the six months ended June 30, 2018, primarily driven by costs related to hedging and exposures to certain emerging market currencies, and
- income of $4 million in the six months ended July 2, 2017, related to an insurance recovery from commercial settlements in Mexico recorded in 2014 and 2016,

partially offset by:

- higher interest income in the six months ended June 30, 2018 due to higher cash balances.

Provision for taxes on income

	Three Months Ended			Six Months Ended		
(MILLIONS OF DOLLARS)	June 30, 2018	July 2, 2017	% Change	June 30, 2018	July 2, 2017	% Change
Provision for taxes on income	$55	$98	(44)	$122	$196	(38)
Effective tax rate	12.6%	28.4%		14.3 %	28.7 %	

Certain amounts and percentages may reflect rounding adjustments.

On December 22, 2017, the Tax Cuts and Jobs Act (the Tax Act) was enacted which, among other changes, reduced the U.S. federal corporate tax rate from 35% to 21% effective January 1, 2018. The Tax Act made broad and complex changes to the U.S. tax code and it will take time to

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fully analyze the impact of the changes. Based on the information available at that time, and the current interpretation of the Tax Act, for the year ended December 31, 2017 the company was able to make a reasonable estimate and recorded an initial provisional net tax expense of $212 million related to the one-time mandatory deemed repatriation tax, payable over eight years, partially offset by the remeasurement of the deferred tax assets and liabilities, as of the date of enactment, due to the reduction in the U.S. federal corporate tax rate. Pursuant to the Staff Accounting Bulletin published by the Securities and Exchange Commission on December 22, 2017, addressing the challenges in accounting for the effects of the Tax Act in the period of enactment, companies must report provisional amounts for those specific income tax effects of the Tax Act for which the accounting is incomplete but a reasonable estimate can be determined. Those provisional amounts will be subject to adjustment during a measurement period of up to one year from the enactment date (measurement-period adjustment). Pursuant to this guidance, the estimated impact of the Tax Act was based on a preliminary review of the new tax law and projected future financial results and is subject to revision based upon further analysis and interpretation of the Tax Act and to the extent that future results differ from currently available projections.

In 2018, we were able to further refine our initial reasonable estimate and adjusted the initial provisional net tax expense of $212 million. On the basis of revised computations that were calculated during the reporting period, we recognized a measurement-period adjustment of $33 million and $35 million for the three and six months ended June 30, 2018, respectively, as a decrease to the one-time mandatory deemed repatriation tax obligation, with a corresponding adjustment to income tax benefit during the period.

Three months ended June 30, 2018 vs. three months ended July 2, 2017

The effective tax rate was 12.6% for the three months ended June 30, 2018, compared with 28.4% for the three months ended July 2, 2017. The lower effective tax rate for the three months ended June 30, 2018, was primarily attributable to:

- the reduction of the U.S. federal corporate income tax rate, from 35% to 21%, effective January 1, 2018, pursuant to the Tax Act;
- a $33 million net discrete tax benefit recorded in the second quarter of 2018, associated with a measurement-period adjustment related to the provisional one-time mandatory deemed repatriation tax on the company's undistributed non-U.S. earnings pursuant to the Tax Act enacted on December 22, 2017;
- 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; and
- a $1 million and $2 million discrete tax benefit recorded in the second quarter of 2018 and 2017, respectively, related to the excess tax benefits for share-based payments.

Six months ended June 30, 2018 vs. six months ended July 2, 2017

The effective tax rate was 14.3% for the six months ended June 30, 2018, compared with 28.7% for the six months ended July 2, 2017. The lower effective tax rate for the six months ended June 30, 2018, was primarily attributable to:

- the reduction of the U.S. federal corporate income tax rate, from 35% to 21%, effective January 1, 2018, pursuant to the Tax Act;
- a $35 million net discrete tax benefit recorded in the first half of 2018, associated with a measurement-period adjustment related to the provisional one-time mandatory deemed repatriation tax on the company's undistributed non-U.S. earnings pursuant to the Tax Act enacted on December 22, 2017;
- 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;
- an $8 million and $7 million discrete tax benefit recorded in the first half of 2018 and 2017, respectively, related to the excess tax benefits for share-based payments; and
- an $8 million and $3 million discrete tax benefit recorded in the first half of 2018 and 2017, respectively, related to a remeasurement of deferred taxes as a result of a change in non-U.S. statutory tax rates.

Operating Segment Results

In the first quarter of 2018, the company realigned certain management responsibilities. These changes did not impact the determination of our operating segments, however they resulted in the reallocation of certain costs between segments. These changes primarily include the following: i) R&D costs related to our aquaculture business which were previously reported in Other business activities are now reported in the international commercial segment results, and ii) certain other miscellaneous costs which were previously reported in Corporate are now reported in the international commercial segment results.

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)	June 30, 2018	July 2, 2017	Total	Foreign Exchange	Operational
U.S.					
Livestock	$271	$269	1	—	1
Companion animal	406	354	15	—	15
	677	623	9	—	9
International					
Livestock	463	420	10	4	6
Companion animal	265	214	24	7	17
	728	634	15	5	10
Total					
Livestock	734	689	7	3	4
Companion animal	671	568	18	2	16
Contract manufacturing	10	12	(17)	(3)	(14)
	$1,415	$1,269	12	3	9

Certain amounts and percentages may reflect rounding adjustments.

	Six Months Ended		% Change	Related to	
(MILLIONS OF DOLLARS)	June 30, 2018	July 2, 2017	Total	Foreign Exchange	Operational
U.S.					
Livestock	$563	$551	2	—	2
Companion animal	748	677	10	—	10
	1,311	1,228	7	—	7
International					
Livestock	941	841	12	5	7
Companion animal	513	408	26	8	18
	1,454	1,249	16	6	10
Total					
Livestock	1,504	1,392	8	3	5
Companion animal	1,261	1,085	16	3	13
Contract manufacturing	16	23	(30)	5	(35)
	$2,781	$2,500	11	3	8

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)	June 30, 2018	July 2, 2017	Total	Related to Foreign Exchange	Operational
U.S.					
Revenue	$677	$623	9	—	9
Cost of Sales	140	134	4	—	4
Gross Profit	537	489	10	—	10
Gross Margin	79.3 %	78.5 %			
Operating Expenses	116	113	3	—	3
Other (income)/deductions	—	—	—	—	—
U.S. Earnings	421	376	12	—	12
International					
Revenue	728	634	15	5	10
Cost of Sales	229	219	5	4	1
Gross Profit	499	415	20	5	15
Gross Margin	68.5 %	65.5 %			
Operating Expenses	147	126	17	5	12
Other (income)/deductions	2	2	—	(44)	44
International Earnings	350	287	22	6	16
Total operating segments	771	663	16	2	14
Other business activities	(82)	(73)	12		
Reconciling Items:					
Corporate	(139)	(151)	(8)		
Purchase accounting adjustments	(23)	(21)	10		
Acquisition-related costs	—	(2)	(100)		
Certain significant items	(7)	1	*		
Other unallocated	(83)	(72)	15		
Income before provision for taxes on income	$437	$345	27		

* Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

(MILLIONS OF DOLLARS)	Six Months Ended June 30, 2018	July 2, 2017	% Change Total	% Change Related to Foreign Exchange	% Change Related to Operational
U.S.					
Revenue	$1,311	$1,228	7	—	7
Cost of Sales	280	271	3	—	3
Gross Profit	1,031	957	8	—	8
Gross Margin	78.6 %	77.9 %			
Operating Expenses	212	209	1	—	1
Other (income)/deductions	—	—	—	—	—
U.S. Earnings	819	748	9	—	9
International					
Revenue	1,454	1,249	16	6	10
Cost of Sales	463	432	7	4	3
Gross Profit	991	817	21	7	14
Gross Margin	68.2 %	65.4 %			
Operating Expenses	280	240	17	7	10
Other (income)/deductions	3	(1)	*	*	*
International Earnings	708	578	22	7	15
Total operating segments	1,527	1,326	15	3	12
Other business activities	(163)	(147)	11		
Reconciling Items:					
Corporate	(292)	(294)	(1)		
Purchase accounting adjustments	(46)	(43)	7		
Acquisition-related costs	(1)	(2)	(50)		
Certain significant items	(10)	(3)	*		
Other unallocated	(161)	(155)	4		
Income before provision for taxes on income	$854	$682	25		

* Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

Three months ended June 30, 2018 vs. three months ended July 2, 2017

U.S. operating segment

U.S. segment revenue increased by $54 million, or 9%, in the three months ended June 30, 2018, compared with the three months ended July 2, 2017, reflecting growth of approximately $52 million in companion animal products and approximately $2 million in livestock products.

- Companion animal revenue growth was driven primarily by increased sales of the dermatology portfolio, as well as new products including Simparica®. Growth was tempered by lower sales of certain in-line products due to anticipated competition.
- Livestock revenue increased primarily due to higher sales of poultry and swine products, offset by declines in the cattle business. For poultry, growth was driven by increased sales of medicated feed additive products. Swine growth was primarily due to new vaccine products. Cattle sales declined due to lower sales of medicated feed additive products.

U.S. segment earnings increased by $45 million, or 12%, in the three months ended June 30, 2018, compared with the three months ended July 2, 2017, primarily due to revenue growth and improved gross margins.

International operating segment

International segment revenue increased by $94 million, or 15%, in the three months ended June 30, 2018, compared with the three months ended July 2, 2017. Operational revenue increased by $64 million, or 10%, driven by growth of approximately $37 million in companion animal products and growth of approximately $27 million in livestock products.

- Companion animal revenue growth resulted primarily from increased sales across multiple international markets of the dermatology portfolio, and new products including Simparica®, as well as growth in vaccines in China.

- Livestock growth was driven primarily by strong performance in the cattle and swine portfolios, partially offset by the national trucking industry strike in Brazil. Cattle growth reflected increases in biological and anti-infective products and swine growth was primarily due to new vaccine products.

Additionally, segment revenue was favorably impacted by foreign exchange, which increased revenue by approximately $30 million, or 5%, primarily driven by the appreciation of the euro, U.K. pound, Chinese renminbi, and Canadian dollar, partially offset by depreciation in the Brazilian Real.

International segment earnings increased by $63 million, or 22%, in the three months ended June 30, 2018, compared with the three months ended July 2, 2017. Operational earnings growth was $45 million, or 16%, primarily due to higher revenue and improved gross margin, partially offset by higher operating expenses.

Six months ended June 30, 2018 vs. six months ended July 2, 2017

U.S. operating segment

U.S. segment revenue increased by $83 million, or 7%, in the six months ended June 30, 2018, compared with the six months ended July 2, 2017, reflecting growth of approximately $71 million in companion animal products and growth of approximately $12 million in livestock products.

- Companion animal revenue growth was driven primarily by increased sales of the dermatology portfolio, as well as new products. Growth was tempered by lower sales of certain in-line products due to anticipated competition.
- Livestock revenue increased primarily due to higher sales of poultry, swine and cattle. For poultry, growth was driven by increased sales of medicated feed additive products. Swine growth was primarily due to new vaccine products.
- Growth of cattle products was driven by favorable market conditions in the beef market, including higher feedlot placements and variable weather conditions, which drove higher disease risk and incidence in the first quarter partially offset by declines in medicated feed additive products and unfavorable market conditions in dairy.

U.S. segment earnings increased by $71 million, or 9%, in the six months ended June 30, 2018, compared with the six months ended July 2, 2017, primarily due to revenue growth and improved gross margins.

International operating segment

International segment revenue increased by $205 million, or 16%, in the six months ended June 30, 2018, compared with the six months ended July 2, 2017. Operational revenue increased by $128 million, or 10%, driven by growth of approximately $73 million in companion animal products and growth of approximately $55 million in livestock products.

- Companion animal revenue growth resulted primarily from increased sales across multiple international markets of the dermatology portfolio, and new products including Simparica®, as well as growth in vaccines in China.
- Livestock growth was driven primarily by strong performance in cattle, poultry and swine products, partially offset by the national trucking industry strike in Brazil. Growth in cattle was due to anti-infective and biological products.
- Growth in poultry products was driven by increased sales of medicated feed additives. Swine growth was primarily due to new vaccine products.

Additionally, segment revenue was favorably impacted by foreign exchange, which increased revenue by approximately $77 million, or 6%, primarily driven by the appreciation of the euro, U.K. pound, Chinese renminbi, and Canadian dollar, partially offset by depreciation in the Brazilian Real.

International segment earnings increased by $130 million, or 22%, in the six months ended June 30, 2018, compared with the six months ended July 2, 2017. Operational earnings growth was $88 million, or 15%, primarily due to higher revenue and improved gross margin, partially offset by higher operating expenses.

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 June 30, 2018 vs. three months ended July 2, 2017

Other business activities net loss increased by $9 million, or 12%, in the three months ended June 30, 2018, compared with the three months ended July 2, 2017, reflecting an increase in R&D project investments, compensation-related

costs, unfavorable foreign exchange, and the inclusion of the Irish biologic therapeutics business acquired in 2017.

Six months ended June 30, 2018 vs. six months ended July 2, 2017

Other business activities net loss increased by $16 million, or 11%, in the six months ended June 30, 2018, compared with the six months ended July 2, 2017, reflecting an increase in R&D project investments, compensation-related costs, unfavorable foreign exchange, and the inclusion of the Irish biologic therapeutics business acquired in 2017.

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 June 30, 2018 vs. three months ended July 2, 2017

Corporate expenses decreased by $12 million, or 8%, in the three months ended June 30, 2018, compared with the three months ended July 2, 2017, primarily due to favorable foreign exchange.

Other unallocated expenses increased by $11 million, or 15%, in the three months ended June 30, 2018, compared with the three months ended July 2, 2017, primarily due to the unfavorable impact of foreign exchange.

Six months ended June 30, 2018 vs. six months ended July 2, 2017

Corporate expenses decreased by $2 million, or 1%, in the six months ended June 30, 2018, compared with the six months ended July 2, 2017, primarily due to favorable foreign exchange partially offset by an increase in certain compensation costs not allocated to our operating segments.

Other unallocated expenses increased by $6 million, or 4%, in the six months ended June 30, 2018, compared with the six months ended July 2, 2017, primarily due to the unfavorable impact of foreign exchange partially offset by continued cost improvements and efficiencies in our manufacturing network, and lower global manufacturing and supply costs.

See Notes to Condensed Consolidated Financial Statements—Note 17. Segment 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. The adjusted net income measure is an important internal measurement for us. Additionally, 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.

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

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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 16. 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.

Reconciliation

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

	Three Months	Six Months Ended

	Ended					
	June 30,	July 2,	%	June 30,	July 2,	%
(MILLIONS OF DOLLARS)	2018	2017	Change	2018	2017	Change
GAAP reported net income attributable to Zoetis	$384	$247	55	$736	$485	52
Purchase accounting adjustments—net of tax	19	15	27	31	34	(9)
Acquisition-related costs—net of tax	—	1	(100)	1	1	—
Certain significant items—net of tax	(28)	(2)	*	(28)	2	*
Non-GAAP adjusted net income[a]	$375	$261	44	$740	$522	42

*Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

[a] The effective tax rate on adjusted pretax income is 20.1% and 28.9% for the three months ended June 30, 2018, and July 2, 2017, respectively. The lower effective tax rate for the three months ended June 30, 2018, compared with the three months ended July 2, 2017, was primarily attributable to (i) the reduction of the U.S. federal corporate income tax rate from 35% to 21%, effective January 1, 2018, pursuant to the Tax Act, (ii) changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings as well as repatriation costs, and (iii) a $1 million and $2 million discrete tax benefit recorded in the second quarter of 2018 and 2017, respectively, related to the excess tax benefits for share-based payments.

The effective tax rate on adjusted pretax income is 19.2% and 28.4% for the six months ended June 30, 2018, and July 2, 2017, respectively. The lower effective tax rate for the six months ended June 30, 2018, compared with the six months ended July 2, 2017, was primarily attributable to (i) the reduction of

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the U.S. federal corporate income tax rate from 35% to 21%, effective January 1, 2018, pursuant to the Tax Act, (ii) changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings as well as repatriation costs, (iii) an $8 million and $7 million discrete tax benefit recorded in the first half of 2018 and 2017, respectively, related to the excess tax benefits for share-based payments, and (iv) a $3 million discrete tax benefit recorded in the first half of 2018 related to a remeasurement of deferred taxes as a result of a change in non-U.S. statutory tax rates.

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		
	June 30, 2018	July 2, 2017	% Change	June 30, 2018	July 2, 2017	% Change
Earnings per share—diluted[(a)]						
GAAP reported EPS attributable to Zoetis—diluted	$0.79	$0.50	58	$1.51	$0.98	54
Purchase accounting adjustments—net of tax	0.04	0.03	33	0.06	0.07	(14)
Acquisition-related costs—net of tax	—	—	—	—	—	—
Certain significant items—net of tax	(0.06)	—	—	(0.06)	0.01	*
Non-GAAP adjusted EPS—diluted	$0.77	$0.53	45	$1.51	$1.06	42

* Calculation not meaningful.

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, restricted stock units, performance-vesting restricted stock units and deferred stock units.

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

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	June 30, 2018	July 2, 2017	June 30, 2018	July 2, 2017
Interest expense, net of capitalized interest	$46	$ 41	$93	$ 82
Interest income	8	3	14	5
Income taxes	94	106	175	207
Depreciation	37	33	70	67
Amortization	4	5	8	9

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

(MILLIONS OF DOLLARS)	Three Months Ended June 30, 2018	Three Months Ended July 2, 2017	Six Months Ended June 30, 2018	Six Months Ended July 2, 2017
Purchase accounting adjustments:				
Amortization and depreciation[a]	$21	$20	$42	$40
Cost of sales[b]	2	1	4	3
Total purchase accounting adjustments—pre-tax	23	21	46	43
Income taxes[c]	4	6	15	9
Total purchase accounting adjustments—net of tax	19	15	31	34
Acquisition-related costs:				
Integration costs	—	2	1	2
Total acquisition-related costs—pre-tax	—	2	1	2
Income taxes[c]	—	1	—	1
Total acquisition-related costs—net of tax	—	1	1	1
Certain significant items:				
Operational efficiency initiative[d]	1	6	1	5
Supply network strategy[e]	3	(4)	5	(1)
Other restructuring charges and cost-reduction/productivity initiatives	3	—	3	—
Other[f]	—	(3)	1	(1)
Total certain significant items—pre-tax	7	(1)	10	3
Income taxes[c]	35	1	38	1
Total certain significant items—net of tax	(28)	(2)	(28)	2
Total purchase accounting adjustments, acquisition-related costs, and certain significant items—net of tax	$(9)	$14	$4	$37

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.

[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 six months ended June 30, 2018, also includes a tax benefit related to the remeasurement of deferred taxes as a result of a change in non-U.S. statutory tax rates.

Income taxes in Purchase accounting adjustments for the three and six months ended July 2, 2017, also includes a tax benefit related to the remeasurement 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 Certain significant items for the three and six months ended June 30, 2018, includes a net tax benefit related to a measurement-period adjustment to the provisional one-time mandatory deemed repatriation tax on the company's undistributed non-U.S. earnings, pursuant to the Tax Act enacted on December 22, 2017.

Income taxes in Certain significant items for the six months ended July 2, 2017, also includes a net charge related to the remeasurement of the company’s deferred tax assets and liabilities, using the rates expected to be in place at the time of the reversal.

[d] For the three and six months ended June 30, 2018, represents employee termination costs of $1 million.

For the three months ended July 2, 2017, represents employee termination costs of $2 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 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.

(e) For the three months ended June 30, 2018, primarily represents consulting fees of $2 million and exit costs of $1 million. For the six months ended June 30, 2018, primarily represents consulting fees of $3 million, employee termination costs of $1 million and exit costs of $1 million.

For the three months ended July 2, 2017, represents accelerated depreciation of $1 million, and a reversal of previously accrued employee termination 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 termination costs of $5 million.

(f) For the three and six months ended June 30, 2018, represents employee termination costs in Europe as a result of initiatives to better align our organizational structure.

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.

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

(MILLIONS OF DOLLARS)	Three Months Ended June 30, 2018	Three Months Ended July 2, 2017	Six Months Ended June 30, 2018	Six Months Ended July 2, 2017
Cost of sales:				
Purchase accounting adjustments	$2	$1	$4	$3
Accelerated depreciation	—	1	—	2
Consulting fees	2	—	3	2
Other	—	1	—	1
Total Cost of sales	4	3	7	8
Selling, general & administrative expenses:				
Purchase accounting adjustments	2	2	3	3
Consulting fees	—	1	—	1
Other	—	—	1	2
Total Selling, general & administrative expenses	2	3	4	6
Research & development expenses:				
Purchase accounting adjustments	—	—	1	1
Total Research & development expenses	—	—	1	1
Amortization of intangible assets:				
Purchase accounting adjustments	19	18	38	36
Total Amortization of intangible assets	19	18	38	36
Restructuring (reversals)/ charges and certain acquisition-related costs:				
Integration costs	—	2	1	2
Employee termination costs	4	(3)	5	(4)
Exit costs	1	1	1	1
Total Restructuring (reversals)/ charges and certain acquisition-related costs	5	—	7	(1)
Other (income)/deductions—net:				
Net loss/(gain) on sale of assets	—	2	—	2
Other	—	(4)	—	(4)
Total Other (income)/deductions—net	—	(2)	—	(2)
Provision for taxes on income	39	8	53	11
Total purchase accounting adjustments, acquisition-related costs, and certain significant items—net of tax	$(9)	$14	$4	$37

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.

Analysis of the condensed consolidated balance sheets
June 30, 2018 vs. December 31, 2017
For a discussion about the changes in Cash and cash equivalents, Short-term borrowings, 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 decreased as a result of the timing of customer collections.
Other current assets increased primarily as a result of the timing of income tax payments, adjustments to the accrual for the income tax provision for the first half of 2018, and higher receivables due to value-added tax for our international markets.

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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 2018, as well as the impact of the remeasurement of deferred taxes as a result of a change in tax rates. See Notes to Condensed Consolidated Financial Statements— Note 8. Income Taxes.

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

Accrued compensation and related items decreased primarily due to payment of 2017 annual bonuses to eligible employees and 2017 employee savings plan contributions, partially offset by the pro rata accrual of similar items for 2018.

Other current liabilities decreased primarily as a result of payments of contingent purchase price consideration associated with prior acquisitions.

For an analysis of the changes in Total Equity, see the Condensed Consolidated Statements of Equity and Notes to Condensed Consolidated Financial Statements— Note 14. Stockholders' Equity.

Analysis of the condensed consolidated statements of cash flows

	Six Months Ended		
(MILLIONS OF DOLLARS)	June 30, 2018	July 2, 2017	% Change
Net cash provided by (used in):			
Operating activities	$656	$299	*
Investing activities	(121)	(88)	38
Financing activities	(533)	(240)	*
Effect of exchange-rate changes on cash and cash equivalents	(8)	7	*
Net increase (decrease) in cash and cash equivalents	$(6)	$(22)	(73)

*Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

Operating activities

Six months ended June 30, 2018 vs. six months ended July 2, 2017

Net cash provided by operating activities was $656 million for the six months ended June 30, 2018, compared with net cash provided by operating activities of $299 million for the six months ended July 2, 2017. The increase in operating cash flows was primarily attributable to higher income before allocation to noncontrolling interests and the timing of receipts and payments in the ordinary course of business.

Investing activities

Six months ended June 30, 2018 vs. six months ended July 2, 2017

Our net cash used in investing activities was $121 million for the six months ended June 30, 2018, compared with net cash used in investing activities of $88 million for the six months ended July 2, 2017. The net cash used in investing activities for 2018 was due primarily to purchases of property, plant and equipment, partially offset by proceeds from the 2017 sale of our manufacturing site in Guarulhos, Brazil. 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.

Financing activities

Six months ended June 30, 2018 vs. six months ended July 2, 2017

Our net cash used in financing activities was $533 million for the six months ended June 30, 2018, compared with net cash used in financing activities of $240 million for the six months ended July 2, 2017. The net cash used in financing activities for 2018 was primarily attributable to the purchase of treasury shares and the payment of dividends. 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.

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.

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Selected measures of liquidity and capital resources

Certain relevant measures of our liquidity and capital resources follow:

(MILLIONS OF DOLLARS)	June 30, 2018	December 31, 2017
Cash and cash equivalents	$1,558	$ 1,564
Accounts receivable, net[(a)]	973	998
Long-term debt	4,955	4,953
Working capital	3,272	3,123
Ratio of current assets to current liabilities	4.38:1	3.85:1

(a) Accounts receivable are usually collected over a period of 60 to 90 days. For the six months ended June 30, 2018, compared with December 31, 2017, 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). In December 2017, the maturity for the amended and restated revolving credit agreement was extended through December 2022. 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 June 30, 2018 and December 31, 2017. There were no amounts drawn under the credit facility as of June 30, 2018 or December 31, 2017.

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 June 30, 2018, we had access to $61 million of lines of credit which expire at various times throughout 2018 and 2019 and are generally renewed annually. We did not have any borrowings outstanding related to these facilities as of June 30, 2018 and December 31, 2017.

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 U.S. state income taxes, foreign withholding taxes and currency gains and losses. We recorded U.S. deferred tax liabilities associated with the one-time mandatory deemed repatriation tax imposed by the Tax Act to the extent amounts earned

overseas are expected to be indefinitely reinvested outside the United States, no accrual for foreign withholding taxes and currency gains and losses 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 September 12, 2017, we issued $1.25 billion aggregate principal amount of our senior notes (2017 senior notes), with an original issue discount of $7 million. These notes are comprised of $750 million aggregate principal amount of 3.000% senior notes due 2027 and $500 million aggregate principal amount of 3.950% senior notes due 2047. Net proceeds from this offering were partially used in October 2017 to repay, prior to maturity, the aggregate principal amount of $750 million, and a make-whole amount and accrued interest of $4 million, of our 1.875% senior notes due 2018. The remainder of the net proceeds will be used for general corporate purposes.

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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 (2013 senior notes) in a private placement, with an original issue discount of $10 million.

The 2013, 2015 and 2017 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 lease-back 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 (if not cured or waived), the 2013, 2015 and 2017 senior notes may be declared immediately due and payable.

Pursuant to the indenture, we are able to redeem the 2013, 2015 and 2017 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, 2015 and 2017 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, 2015 and 2017 senior notes at a price equal to 101% of the aggregate principal amount of the 2013, 2015 and 2017 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
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
2017 Senior Note due 2027	$750 million	3.000%	Interest due semi annually, not subject to amortization, aggregate principal due on September 12, 2027
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
2017 Senior Note due 2047	$500 million	3.950%	Interest due semi annually, not subject to amortization, aggregate principal due on September 12, 2047

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. 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	Baa1	Stable	August 2017
S&P	A-2	BBB	Stable	December 2016

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 2018, approximately 5 million shares were repurchased. As of June 30, 2018, there was approximately $595 million 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 June 30, 2018, or December 31, 2017, recorded amounts for the estimated fair value of these indemnifications are not significant.

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New accounting standards

Recently Issued Accounting Standards Not Adopted as of June 30, 2018.

In February 2018, the FASB issued an accounting standards update which permits companies to reclassify from accumulated other comprehensive income to retained earnings stranded tax effects resulting from the new federal corporate income tax rate. In the period of adoption, a company may choose to either apply the amendments retrospectively to each period in which the effect of the change in federal income tax rate is recognized or to apply the amendments in that reporting period. The provisions of the update are effective beginning January 1, 2019 for interim and annual periods, with early adoption permitted for any interim period after issuance of the update. We are currently assessing the timing of our adoption and do not expect that 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 have selected a lease accounting system which we are in the process of implementing, while continuing to evaluate our lease contracts, accounting policy elections, and the impact of adoption on our consolidated financial statements. While we do not expect adoption of the standard to have a significant impact on our consolidated statements of income, the impact on the assets and liabilities within our consolidated balance sheet may be material.

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 2018 financial guidance, 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, integration of acquired businesses, 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, 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;
- unanticipated safety, quality or efficacy concerns about or issues related to 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, 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;
- consolidation of our customers and distributors negatively affecting the pricing of our products;
- 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;

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- 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, Chinese renminbi, 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 June 30, 2018, 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 June 30, 2018, 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 $22 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 $29 million. For additional details, see Notes to Condensed Consolidated Financial Statements— Note 9B. 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 June 30, 2018, there were no commercial paper borrowings outstanding and no outstanding principal balance under our revolving credit facility. See Notes to Condensed Consolidated Financial Statements— Note 9B. 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 June 30, 2018, 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 16. 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 2017 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 2017 Annual Report on Form 10-K.

Risks related to our business and industry

Modification of foreign trade policy by the U.S. or foreign countries or the imposition of tariffs on U.S. or foreign goods may harm our business.

Changes in U.S. laws, agreements and policies governing foreign trade in the territories and countries where our customers do business could negatively impact such customers' businesses and adversely affect our operating results. A number of our customers, particularly U.S.-based livestock producers, benefit from free trade agreements such as the North American Free Trade Agreement (NAFTA). The current President of the United States has initiated negotiations with Canada and Mexico aimed at re-negotiating the terms of NAFTA. Changes to international trade agreements or policies could harm our customers, and as a result, negatively impact our financial condition and results of operations.

Additionally, in March 2018, the United States announced tariffs on certain foreign goods imported into the U.S. In response, some foreign governments, including China, have instituted or are considering instituting tariffs on certain U.S. goods. While the scope and duration of these and any future tariffs remains uncertain, tariffs imposed by the U.S. or foreign governments on our products or the active pharmaceutical ingredients or other components thereof could negatively impact our financial condition and results of operations.

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.

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 still under consideration and may have an impact to our effective tax rate.

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (the Tax Act) effective January 1, 2018. Some notable provisions of the Tax Act include a reduction of the corporate income tax rate from 35% to 21%, and a change from a worldwide system with deferral to a territorial tax system, which includes a one-time mandatory deemed repatriation tax, payable over eight years, on certain undistributed earnings of non-U.S. subsidiaries. As of

December 31, 2017, the cumulative amount of non-U.S. undistributed earnings was approximately $4.5 billion, which includes an allocation of non-U.S. undistributed earnings as a result of the separation from Pfizer on June 24, 2013. Pursuant to the Staff Accounting Bulletin published by the Securities and Exchange Commission on December 22, 2017, addressing the challenges in accounting for the effects of the Tax Act in the period of enactment, companies must report provisional amounts for those specific income tax effects of the Tax Act for which the accounting is incomplete but a reasonable estimate can be determined. Those provisional amounts will be subject to adjustment during a measurement period of up to one year from the enactment date. The company is currently in the process of evaluating the full impact of this new legislation on its consolidated financial statements, and in the fourth quarter of 2017 recorded a provisional net charge of $212 million related to the one-time mandatory deemed repatriation tax, partially offset by the remeasurement of the deferred tax assets and liabilities, as of the date of enactment, due to the reduction in the U.S. federal corporate tax rate. A measurement-period adjustment was recorded in the first half of 2018 as a decrease to income tax expense of $35 million. 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.

Risks related to our indebtedness

We have substantial indebtedness.

We have a significant amount of indebtedness, which could materially adversely affect our operating results, financial condition and liquidity. As of June 30, 2018, we had approximately $5.0 billion of total unsecured indebtedness outstanding. In addition, we currently have agreements for a five-year revolving credit facility with a capacity of up to $1.0 billion, a 364-day revolving credit facility with a capacity of up to $0.5 billion and a commercial paper program with a capacity of up to $1.0 billion. As of August 2, 2018, we have $0.5 billion drawn under the 364-day revolving credit facility and have issued $0.5 billion of commercial paper under our commercial paper program in connection with the closing of our acquisition of Abaxis, Inc. We may also incur additional indebtedness under these arrangements in the future.

We may incur substantial additional debt from time to time to finance working capital, capital expenditures, investments or acquisitions, or for other purposes. If we do so, the risks related to our high level of debt could intensify. Specifically, our high level of debt could have important consequences, including:

- making it more difficult for us to satisfy our obligations with respect to our debt;
- limiting our ability to obtain additional financing to fund future working capital, capital expenditures, business development or other general corporate requirements, including dividends;
- increasing our vulnerability to general adverse economic and industry conditions;
- exposing us to the risk of increased interest rates as certain of our borrowings are and may in the future be at variable rates of interest;
- limiting our flexibility in planning for and reacting to changes in the animal health industry;
- placing us at a competitive disadvantage to other, less leveraged competitors;
- impacting our effective tax rate; and
- increasing our cost of borrowing.

In addition, the instruments governing our indebtedness contain restrictive covenants that will limit our ability to engage in activities that may be in our long-term best interest. For example, each of our credit facilities contains a financial covenant requiring us to not exceed a maximum total leverage ratio and covenants that, among other things, limit or restrict our and our subsidiaries' ability, subject to certain exceptions, to incur liens, merge, consolidate or sell, transfer or lease assets, transact with affiliates and incur priority indebtedness. Our failure to comply with such covenants could result in an event of default which, if not cured or waived, could result in the acceleration of all our debt.

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

June 30, 2018:

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 1 - April 30, 2018	929,873	$83.29	930,201	$732,487,712
May 1 - May 31, 2018	848,044	$83.10	847,118	$662,075,844
June 1 - June 30, 2018	776,783	$86.15	776,381	$595,180,803
	2,554,700	$84.10	2,553,700	$595,180,803

(a) The company repurchased 1,000 shares during the three-month period ended June 30, 2018, 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 10.1	364-Day Revolving Credit Agreement, dated as of July 27, 2018, among Zoetis Inc., the lenders party thereto and Barclays Bank PLC, as administrative agent
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 2, 2018 By: /S/ JUAN RAMÓN ALAIX
Juan Ramón Alaix
Chief Executive Officer and Director

August 2, 2018 By: /S/ GLENN DAVID
Glenn David
Executive Vice President and
Chief Financial Officer