Merck & Co. Inc.
Form 10-Q
May 07, 2010

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

(Mark One)

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

For the quarterly period ended March 31, 2010

OR

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

For the transition period from _____ to _____

Commission File No. 1-6571

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

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

The number of shares of common stock outstanding as of the close of business on April 30, 2010: 3,118,252,244

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No o

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

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o	Smaller reporting company o
		(Do not check if a smaller reporting company)	

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

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Part I Financial Information
Item 1. Financial Statements

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

	Three Months Ended March 31,	
	2010	2009
Sales	$11,422.2	$5,385.2
Costs, Expenses and Other		
Materials and production	5,215.6	1,333.8
Marketing and administrative	3,246.2	1,632.9
Research and development	2,026.7	1,224.2
Restructuring costs	287.7	64.3
Equity income from affiliates	(137.5)	(585.8)
Other (income) expense, net	167.7	(67.2)
	10,806.4	3,602.2
Income Before Taxes	615.8	1,783.0
Taxes on Income	285.6	327.2
Net Income	$ 330.2	$1,455.8
Less: Net Income Attributable to Noncontrolling Interests	31.4	30.8
Net Income Attributable to Merck & Co., Inc.	$ 298.8	$1,425.0
Basic Earnings per Common Share Attributable to Merck & Co., Inc. Common Shareholders	$ 0.10	$ 0.67
Earnings per Common Share Assuming Dilution Attributable to Merck & Co., Inc. Common Shareholders	$ 0.09	$ 0.67
Dividends Declared per Common Share	$ 0.38	$ 0.38

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

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

	March 31, 2010	December 31, 2009
Assets		
Current Assets		
Cash and cash equivalents	$ 8,236.0	$ 9,311.4
Short-term investments	1,541.3	293.1
Accounts receivable (net of allowance for doubtful accounts of $106.2 in 2010 and $112.6 in 2009)	7,497.7	6,602.9
Inventories (excludes inventories of $1,312.6 in 2010 and $1,157.2 in 2009 classified in Other assets - see Note 7)	6,825.4	8,057.5
Deferred income taxes and other current assets	4,144.5	4,199.9
Total current assets	28,244.9	28,464.8
Investments	1,995.0	432.3
Property, Plant and Equipment, at cost, net of allowance for depreciation of $12,220.3 in 2010 and $12,594.7 in 2009	17,985.0	18,257.9
Goodwill	12,266.2	12,140.0
Other Intangibles, Net	45,574.9	47,778.3
Other Assets	5,527.8	5,376.4
	$111,593.8	$112,449.7
Liabilities and Equity		
Current Liabilities		
Loans payable and current portion of long-term debt	$ 3,822.4	$ 1,379.3
Trade accounts payable	2,074.9	2,239.1
Accrued and other current liabilities	8,439.0	9,457.8
Income taxes payable	723.0	1,258.2
Dividends payable	1,189.8	1,189.0
6% Mandatory convertible preferred stock, $1 par value Authorized - 11,500,000 shares Issued and outstanding - 853,896 shares in 2010 and 855,422 shares in 2009	206.2	206.6
Total current liabilities	16,455.3	15,730.0
Long-Term Debt	15,281.1	16,095.1

Deferred Income Taxes and Noncurrent Liabilities	19,514.2	19,132.0
Merck & Co., Inc. Stockholders Equity		
Common stock, $0.50 par value		
Authorized - 6,500,000,000 shares		.
Issued - 3,571,947,847 shares in 2010; 3,562,528,536 shares in 2009	1,786.0	1,781.3
Other paid-in capital	40,196.6	39,682.6
Retained earnings	40,511.4	41,404.9
Accumulated other comprehensive loss	(3,571.6)	(2,766.5)
	78,922.4	80,102.3
Less treasury stock, at cost		
454,305,985 shares in 2010 and 2009	21,044.3	21,044.3
Total Merck & Co., Inc. stockholders equity	57,878.1	59,058.0
Noncontrolling Interests	2,465.1	2,434.6
Total equity	60,343.2	61,492.6
	$111,593.8	$112,449.7

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

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

	Three Months Ended March 31,	
	2010	2009
Cash Flows from Operating Activities		
Net income	$ 330.2	$ 1,455.8
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,687.4	443.3
Equity income from affiliates	(137.5)	(585.8)
Dividends and distributions from equity affiliates	77.4	456.6
Deferred income taxes	152.2	153.6
Share-based compensation	132.4	113.3
Other	188.0	90.5
Net changes in assets and liabilities	(1,064.0)	(1,414.7)
Net Cash Provided by Operating Activities	1,366.1	712.6
Cash Flows from Investing Activities		
Capital expenditures	(342.8)	(235.1)
Purchases of securities and other investments	(2,932.7)	(2,045.0)
Proceeds from sales of securities and other investments	272.7	3,119.1
Acquisitions of businesses, net of cash acquired	(131.3)	(130.0)
(Increase) decrease in restricted assets	(25.1)	684.5
Other	11.1	(3.4)
Net Cash (Used by) Provided by Investing Activities	(3,148.1)	1,390.1
Cash Flows from Financing Activities		
Net change in short-term borrowings	2,620.4	511.7
Payments on debt	(622.3)	(7.5)
Dividends paid to stockholders	(1,188.6)	(803.5)
Proceeds from exercise of stock options	195.3	0.4
Other	(62.6)	(93.0)
Net Cash Provided by (Used by) Financing Activities	942.2	(391.9)
Effect of Exchange Rate Changes on Cash and Cash Equivalents	(235.6)	(62.0)
Net (Decrease) Increase in Cash and Cash Equivalents	(1,075.4)	1,648.8
Cash and Cash Equivalents at Beginning of Year	9,311.4	4,368.3

Cash and Cash Equivalents at End of Period	$ 8,236.0	$ 6,017.1

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

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Notes to Consolidated Financial Statements (unaudited)

1. Basis of Presentation

The accompanying unaudited interim consolidated financial statements have been prepared pursuant to the rules and regulations for reporting on Form 10-Q. Accordingly, certain information and disclosures required by accounting principles generally accepted in the United States for complete consolidated financial statements are not included herein. The interim statements should be read in conjunction with the audited financial statements and notes thereto included in Merck & Co., Inc. s Form 10-K filed on March 1, 2010.

On November 3, 2009, Merck & Co., Inc. (Old Merck) and Schering-Plough Corporation (Schering-Plough) completed their previously-announced merger (the Merger). In the Merger, Schering-Plough acquired all of the shares of Old Merck, which became a wholly-owned subsidiary of Schering-Plough and was renamed Merck Sharp & Dohme Corp. Schering-Plough continued as the surviving public company and was renamed Merck & Co., Inc. (New Merck or the Company). However, for accounting purposes only, the Merger was treated as an acquisition with Old Merck considered the accounting acquirer. The results of Schering-Plough s business have been included in New Merck s financial statements only for periods subsequent to the completion of the Merger. Accordingly, the accompanying financial statements reflect Old Merck s stand-alone operations as they existed prior to the completion of the Merger. References in these financial statements to Merck for periods prior to the Merger refer to Old Merck and for periods after the completion of the Merger to New Merck.

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

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

Recently Adopted Accounting Standards

In June 2009, the Financial Accounting Standards Board (FASB) issued an amendment to the accounting and disclosure requirements for transfers of financial assets, which is effective January 1, 2010. The amendment eliminates the concept of a qualifying special-purpose entity, changes the requirements for derecognizing financial assets and requires enhanced disclosures to provide financial statement users with greater transparency about transfers of financial assets, including securitization transactions, and an entity s continuing involvement in and exposure to the risks related to transferred financial assets. The effect of adoption on the Company s financial position and results of operations was not material.

Also, in June 2009, the FASB amended the existing accounting and disclosure guidance for the consolidation of variable interest entities, which is effective January 1, 2010. The amended guidance requires enhanced disclosures intended to provide users of financial statements with more transparent information about an enterprise s involvement in a variable interest entity. The effect of adoption on the Company s financial position and results of operations was not material.

Recently Issued Accounting Standards

In October 2009, the FASB issued new guidance for revenue recognition with multiple deliverables, which is effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, although early adoption is permitted. This guidance eliminates the residual method under the current guidance and replaces it with the relative selling price method when allocating revenue in a multiple deliverable arrangement. The selling price for each deliverable shall be determined using vendor specific objective evidence of selling price, if it exists, otherwise third-party evidence of selling price shall be used. If neither exists for a deliverable, the vendor shall use its best estimate of the selling price for that deliverable. After

adoption, this guidance will also require expanded qualitative and quantitative disclosures. The Company is currently assessing the impact of adoption on its financial position and results of operations.

In January 2010, the FASB amended the existing disclosure guidance on fair value measurements, which is effective January 1, 2010, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements, which is effective January 1, 2011. Among other things, the updated guidance requires additional disclosure for the amounts of significant transfers in and out of Level 1 and Level 2 measurements and requires certain Level 3 disclosures on a gross basis. Additionally, the updates amend existing guidance to require a greater level of disaggregated information and more robust disclosures about valuation techniques and inputs to fair value measurements. Since the amended guidance requires only additional disclosures, the adoption of the provisions effective January 1, 2010 did not, and for the provisions effective in 2011 will not, impact the Company s financial position or results of operations.

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Notes to Consolidated Financial Statements (unaudited) (continued)

2. Merger

On November 3, 2009, Old Merck and Schering-Plough completed the Merger for aggregate consideration of $49.6 billion. The Merger expanded the Company s pipeline of product candidates, broadened the Company s commercial portfolio, expanded its global presence and increased its manufacturing capabilities. Additionally, the Company expects to realize substantial cost savings and synergies, including opportunities for consolidation in both sales and marketing and research and development.

A preliminary allocation of the consideration transferred to the net assets of Schering-Plough was made as of the Merger date. During the first quarter of 2010, the Company adjusted the preliminary values assigned to certain assets and liabilities in order to reflect additional information obtained since the Merger date. The opening balance has been adjusted to reflect these changes the most significant of which included an increase to *Other intangibles, net* of $122.5 million, an increase to *Deferred income taxes and noncurrent liabilities* of $360.5 million and an increase to *Goodwill* of $216.9 million. Additional adjustments to the preliminary values of assets and liabilities recognized in the Merger may occur as the allocation of the consideration transferred is finalized during 2010. Under business combinations accounting guidance, the Company has up to one year from the date of the Merger to finalize the allocation of the consideration transferred.

Also, during the first quarter of 2010, the Company recorded $27 million of impairment charges associated with in-process research and development (IPR&D) for previously in-licensed projects capitalized in connection with the Merger that were subsequently abandoned in connection with Company s pipeline prioritization review and returned to the respective licensors.

Schering-Plough s results of operations have been included in New Merck s financial statements for periods subsequent to the completion of the Merger. The following unaudited supplemental pro forma data presents consolidated information as if the Merger had been completed on January 1, 2009:

	Three Months Ended March 31, 2009
Sales	$ 10,683.0
Net income attributable to Merck & Co., Inc.	6,884.1
Basic earnings per common share attributable to Merck & Co., Inc. common shareholders	2.22
Earnings per common share assuming dilution attributable to Merck & Co., Inc. common shareholders	2.22

The unaudited supplemental pro forma data reflect the application of the following adjustments:

The consolidation of the Merck/Schering-Plough partnership (the MSP Partnership) which is now owned 100% by the Company and the corresponding gain resulting from the Company s remeasurement of its previously held equity interest in the MSP Partnership;

Additional depreciation and amortization expense that would have been recognized assuming fair value adjustments to inventory, property, plant and equipment and intangible assets;

Additional interest expense and financing costs that would have been incurred on borrowing arrangements and loss of interest income on cash and short-term investments used to fund the Merger;

Transaction costs associated with the Merger; and

Conversion of a portion of outstanding 6% mandatory convertible preferred stock

The unaudited supplemental pro forma financial information does not reflect the potential realization of cost savings relating to the integration of the two companies. The pro forma data should not be considered indicative of the results that would have occurred if the Merger and related borrowings had been consummated on January 1, 2009, nor are they indicative of future results.

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Notes to Consolidated Financial Statements (unaudited) (continued)

3. Restructuring

Merger Restructuring Program

In February 2010, the Company announced the first phase of a new global restructuring program (the Merger Restructuring Program) in conjunction with the integration of the legacy Merck and legacy Schering-Plough businesses. This Merger Restructuring Program is intended to optimize the cost structure of the combined Company. As part of the first phase of the Merger Restructuring Program, by the end of 2012, the Company expects to reduce its total workforce by approximately 15% across all areas of the Company worldwide. The Company also plans to eliminate 2,500 vacant positions as part of the first phase of the program. These workforce reductions will primarily come from the elimination of duplicative positions in sales, administrative and headquarters organizations, as well as from the consolidation of certain manufacturing facilities and research and development operations. The Company will continue to hire new employees in strategic growth areas of the business during this period. As of March 31, 2010, approximately 5,290 positions have been eliminated in connection with the Merger Restructuring Program, comprised of employee separations, and the elimination of contractors and vacant positions. Certain actions, such as the ongoing reevaluation of manufacturing and research and development facilities worldwide have not yet been completed, but will be included later in 2010 in other phases of the Merger Restructuring Program.

In connection with the Merger Restructuring Program, separation costs under the Company s existing severance programs worldwide were recorded in the fourth quarter of 2009 to the extent such costs were probable and reasonably estimable. The Company commenced accruing costs related to enhanced termination benefits offered to employees under the Merger Restructuring Program in the first quarter of 2010 when the necessary criteria were met. The Company recorded total pretax restructuring costs of $283.2 million in the first quarter of 2010. Since inception of the Merger Restructuring Program through March 31, 2010, Merck has recorded total pretax accumulated costs of $1.7 billion. This first phase of the Merger Restructuring Program is expected to be completed by the end of 2012 with the total pretax costs estimated to be $2.6 billion to $3.3 billion. The Company estimates that approximately 85% of the cumulative pretax costs relate to cash outlays, primarily related to employee separation expense. Approximately 15% of the cumulative pretax costs are non-cash, relating primarily to the accelerated depreciation of facilities to be closed or divested.

2008 Global Restructuring Program

In October 2008, Old Merck announced a global restructuring program (the 2008 Restructuring Program) to reduce its cost structure, increase efficiency, and enhance competitiveness. As part of the 2008 Restructuring Program, the Company expects to eliminate approximately 7,200 positions 6,800 active employees and 400 vacancies across all areas of the Company worldwide by the end of 2011. About 40% of these total reductions will occur in the United States. As of March 31, 2010, approximately 5,445 positions have been eliminated in connection with the 2008 Restructuring Program, comprised of employee separations and the elimination of contractors and vacant positions. The program includes the roll out of a new, more customer-centric selling model. The Company is also making greater use of outside technology resources, centralizing common sales and marketing activities, and consolidating and streamlining its operations. Merck s manufacturing division is further focusing its capabilities on core products and outsourcing non-core manufacturing. This program also included the implementation of a new model for its basic research global operating strategy at legacy Merck Research Laboratories sites.

Pretax restructuring costs of $64.9 million and $174.6 million were recorded in the first quarter of 2010 and 2009, respectively, related to the 2008 Restructuring Program. Since inception of the 2008 Restructuring Program through March 31, 2010, Merck has recorded total pretax accumulated costs of $1.5 billion. The 2008 Restructuring Program is expected to be completed by the end of 2011 with the total pretax costs estimated to be

$1.6 billion to $2.0 billion. The Company estimates that two-thirds of the cumulative pretax costs relate to cash outlays, primarily from employee separation expense. Approximately one-third of the cumulative pretax costs are non-cash, relating primarily to the accelerated depreciation of facilities to be closed or divested.

The Company anticipates that total costs in 2010 associated with restructuring activities for the Merger Restructuring Program and the 2008 Restructuring Program will be in the range of $700 million to $900 million.

For segment reporting, restructuring charges are unallocated expenses.

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Notes to Consolidated Financial Statements (unaudited) (continued)

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

	Three Months Ended March 31, 2010			
($ in millions)	Separation Costs	Accelerated Depreciation	Other	Total
Merger Restructuring Program				
Materials and production	$	$ 25.1	$	$ 25.1
Research and development			6.2	6.2
Restructuring costs	208.7		43.2	251.9
	$208.7	$ 25.1	$49.4	$283.2
2008 Restructuring Program				
Materials and production	$	$ 29.1	$	$ 29.1
Research and development				
Restructuring costs	19.0		16.8	35.8
	$ 19.0	$ 29.1	$16.8	$ 64.9
	$227.7	$ 54.2	$66.2	$348.1

	Three Months Ended March 31, 2009			
($ in millions)	Separation Costs	Accelerated Depreciation	Other	Total
2008 Restructuring Program				
Materials and production	$	$ 21.4	$ 0.8	$ 22.2
Research and development		86.0	2.1	88.1
Restructuring costs	28.2		36.1	64.3
	$ 28.2	$107.4	$39.0	$174.6

Separation costs are associated with actual headcount reductions, as well as those headcount reductions which were probable and could be reasonably estimated. In the first quarter of 2010, approximately 5,685 positions were eliminated, of which 5,150 positions related to the Merger Restructuring Program and 535 positions related to the 2008 Restructuring Program. In the first quarter of 2009, approximately 1,050 positions were eliminated in connection with the 2008 Restructuring Program. These position eliminations were comprised of actual headcount reductions, and the elimination of contractors and vacant positions.

Accelerated depreciation costs primarily relate to manufacturing and research facilities to be sold or closed as part of the programs. All of the sites have and will continue to operate up through the

respective closure dates, and since future cash flows were sufficient to recover the respective book values, Merck was required to accelerate depreciation of the site assets rather than write them off immediately. The site assets include manufacturing and research facilities and equipment.

Other activity of $66.2 million and $39.0 million for the first quarter of 2010 and 2009, respectively, reflects costs that include curtailment, settlement and termination charges associated with pension and other postretirement benefit plans (see Note 13), as well as asset abandonment, shut-down and other related costs.

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Notes to Consolidated Financial Statements (unaudited) (continued)

The following table summarizes the charges and spending relating to Merger Restructuring Program and 2008 Restructuring Program activities for the three months ended March 31, 2010:

($ in millions)	Separation Costs	Accelerated Depreciation	Other	Total
Merger Restructuring Program				
Restructuring reserves as of January 1, 2010	$ 1,303.4	$	$	$ 1,303.4
Expense	208.7	25.1	49.4	283.2
(Payments) receipts, net	(364.8)		(53.3)	(418.1)
Non-cash activity		(25.1)	3.9	(21.2)
Restructuring reserves as of March 31, 2010 [(1)]	$ 1,147.3	$	$	$ 1,147.3
2008 Restructuring Program				
Restructuring reserves as of January 1, 2010	$ 249.3	$	$	$ 249.3
Expense	19.0	29.1	16.8	64.9
(Payments) receipts, net	(42.5)		(18.7)	(61.2)
Non-cash activity		(29.1)	1.9	(27.2)
Restructuring reserves as of March 31, 2010 [(1)]	$ 225.8	$	$	$ 225.8

[(1)] *The cash outlays associated with the first phase of the Merger Restructuring Program are expected to be substantially completed by the end of 2012. The cash outlays associated with the remaining restructuring reserve for the 2008 Restructuring Program are expected to be completed by the end of 2011.*

Legacy Schering-Plough Program

Prior to the Merger, Schering-Plough commenced a Productivity Transformation Program which was designed to reduce and avoid costs and increase productivity. As of January 1, 2010, the Company had a reserve of $79.7 million related to this program. During the first quarter of 2010, the Company recorded $2.6 million of accelerated depreciation costs included in *Materials and production* costs. During the first quarter of 2010, the Company made payments of $10.9 million under this plan, resulting in a remaining reserve of $68.8 million at March 31, 2010. Approximately 45 positions were eliminated in connection with this program during the first quarter of 2010.

4. Acquisitions

In February 2010, the Company completed the acquisition of Avecia Biologics Limited (Avecia) for a total purchase price of approximately $190 million. Avecia is a contract manufacturing organization with specific expertise in microbial-derived biologics. Under the terms of the agreement, the Company acquired Avecia and all of its assets, including all of Avecia s process development and scale-up, manufacturing, quality and business support operations located in Billingham, United Kingdom. The transaction was accounted for as a business combination; accordingly, the assets acquired and liabilities assumed were recorded at their respective fair values as of the acquisition date. The determination of fair value requires management to make significant estimates and assumptions. In connection with the acquisition, substantially all of the purchase price was allocated to Avecia s property, plant and equipment and goodwill. The remaining net assets acquired were not material. This transaction closed on February 1, 2010, and accordingly, the results of operations of the acquired business have been included in the Company s results of operations beginning after the acquisition date. Pro forma financial information has not been included because Avecia s historical financial results are not significant when compared with the Company s financial results.

5. Collaborative Arrangements

The Company continues its strategy of establishing external alliances to complement its substantial internal research capabilities, including research collaborations, licensing preclinical and clinical compounds and technology platforms to drive both near- and long-term growth. The Company supplements its internal research with an aggressive licensing and external alliance strategy focused on the entire spectrum of collaborations from early research to late-stage compounds, as well as new technologies across a broad range of therapeutic areas. These arrangements often include upfront payments and royalty or profit share payments,

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Notes to Consolidated Financial Statements (unaudited) (continued)

contingent upon the occurrence of certain future events linked to the success of the asset in development, as well as expense reimbursements or payments to the third party.

Cozaar/Hyzaar

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

Remicade/Simponi

In 1998, a subsidiary of Schering-Plough entered into a licensing agreement with Centocor, Inc. (Centocor), now a Johnson & Johnson company, to market *Remicade,* which is prescribed for the treatment of inflammatory diseases. In 2005, Schering-Plough s subsidiary exercised an option under its contract with Centocor for license rights to develop and commercialize *Simponi* (golimumab), a fully human monoclonal antibody. The Company has exclusive marketing rights to both products outside the United States, Japan and certain Asian markets. In December 2007, Schering-Plough and Centocor revised their distribution agreement regarding the development, commercialization and distribution of both *Remicade* and *Simponi*, extending the Company s rights to exclusively market *Remicade* to match the duration of the Company s exclusive marketing rights for *Simponi*. In addition, Schering-Plough and Centocor agreed to share certain development costs relating to *Simponi s* auto-injector delivery system. On October 6, 2009, the European Commission approved *Simponi* as a treatment for rheumatoid arthritis and other immune system disorders in two presentations a novel auto-injector and a prefilled syringe. As a result, the Company s marketing rights for both products extend for 15 years from the first commercial sale of *Simponi* in the European Union (EU) following the receipt of pricing and reimbursement approval within the EU. After operating expenses and subject to certain adjustments, the Company is entitled to receive an approximate 60% share of profits on the Company s distribution in the Company s marketing territory through December 31, 2009. Beginning in 2010, the share of profits will change over time to a 50% share of profits by 2014 for both products and the share of profits will remain fixed thereafter for the remainder of the term. The Company may independently develop and market *Simponi* for a Crohn s disease indication in its territories, with an option for Centocor to participate. See Note 10 for a discussion of the arbitration involving the *Remicade/Simponi* product rights.

6. Financial Instruments

Derivative Instruments and Hedging Activities

The Company manages the impact of foreign exchange rate movements and interest rate movements on its earnings, cash flows and fair values of assets and liabilities through operational means and through the use of various financial instruments, including derivative instruments.

A significant portion of the Company s revenues and earnings in foreign affiliates is exposed to changes in foreign exchange rates. The objectives and accounting related to the Company s foreign currency risk management program, as well as its interest rate risk management activities are discussed below.

Foreign Currency Risk Management

A significant portion of the Company s revenues are denominated in foreign currencies. Merck relies on sustained cash flows generated from foreign sources to support its long-term commitment to U.S. dollar-based research and development. To the extent the dollar value of cash flows is diminished as a result of a strengthening dollar, the Company s ability to fund research and other dollar-based strategic initiatives at a consistent level may be impaired. The Company has established revenue hedging and balance sheet risk management programs to protect against volatility of future foreign currency cash flows and changes in fair value caused by volatility in foreign exchange rates at its U.S. functional currency entities.

The objective of the revenue hedging program is to reduce the potential for longer-term unfavorable changes in foreign exchange to decrease the U.S. dollar value of future cash flows derived from foreign currency denominated sales, primarily the euro and Japanese yen. To achieve this objective, the Company will partially hedge forecasted foreign currency denominated third-party and intercompany distributor entity sales that are expected to occur over its planning cycle, typically no more than three years into the future. The Company will layer in hedges over time, increasing the portion of third-party and intercompany distributor entity sales hedged as it gets closer to the expected date of the forecasted foreign currency denominated sales, such that it is probable the hedged transaction will occur. The portion of sales hedged is based on assessments of cost-benefit profiles that consider natural offsetting exposures, revenue and exchange rate volatilities and correlations, and the cost of hedging instruments. The hedged anticipated sales are a specified component of a portfolio of similarly denominated foreign currency-based sales transactions, each of which responds to

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Notes to Consolidated Financial Statements (unaudited) (continued)

the hedged risk in the same manner. The Company manages its anticipated transaction exposure principally with purchased local currency put options, which provide the Company with a right, but not an obligation, to sell foreign currencies in the future at a predetermined price. If the U.S. dollar strengthens relative to the currency of the hedged anticipated sales, total changes in the options cash flows offset the decline in the expected future U.S. dollar cash flows of the hedged foreign currency sales. Conversely, if the U.S. dollar weakens, the options value reduces to zero, but the Company benefits from the increase in the value of the anticipated foreign currency cash flows. The Company also utilizes forward contracts in its revenue hedging program. If the U.S. dollar strengthens relative to the currency of the hedged anticipated sales, the increase in the fair value of the forward contracts offsets the decrease in the expected future U.S. dollar cash flows of the hedged foreign currency sales. Conversely, if the U.S. dollar weakens, the decrease in the fair value of the forward contracts offsets the increase in the value of the anticipated foreign currency cash flows.

The fair values of these derivative contracts are recorded as either assets (gain positions) or liabilities (loss positions) in the Consolidated Balance Sheet. Changes in the fair value of derivative contracts are recorded each period in either current earnings or *Other comprehensive income* (OCI), depending on whether the derivative is designated as part of a hedge transaction, and if so, the type of hedge transaction. Accordingly, for derivatives that are designated as cash flow hedges, the effective portion of the unrealized gains or losses on these contracts is recorded in *Accumulated other comprehensive income* (AOCI) and reclassified into *Sales* when the hedged anticipated revenue is recognized. The hedge relationship is highly effective and hedge ineffectiveness has been *de minimis*. For those derivatives which are not designated as cash flow hedges, unrealized gains or losses are recorded to *Sales* each period. The Company does not enter into derivatives for trading or speculative purposes. The cash flows from these contracts are reported as operating activities in the Consolidated Statement of Cash Flows.

Where the U.S. dollar is the functional currency of the Company s foreign subsidiaries, the primary objective of the balance sheet risk management program is to protect the U.S. dollar value of foreign currency denominated net monetary assets from the effects of volatility in foreign exchange that might occur prior to their conversion to U.S. dollars. In these instances, Merck principally utilizes forward exchange contracts, which enable the Company to buy and sell foreign currencies in the future at fixed exchange rates and economically offset the consequences of changes in foreign exchange on the amount of U.S. dollar cash flows derived from the net assets. Where the U.S. dollar is not the functional currency of the Company s foreign subsidiaries, Merck executes spot trades to convert foreign currencies into U.S. dollars based on short-term forecast needs. These U.S. dollar proceeds are then invested until required by the Company s foreign subsidiaries. Merck routinely enters into contracts to offset the effects of exchange on exposures denominated in developed country currencies, primarily the euro and Japanese yen. For exposures in developing country currencies, the Company will enter into forward contracts to partially offset the effects of exchange on exposures when it is deemed economical to do so based on a cost-benefit analysis that considers the magnitude of the exposure, the volatility of the exchange rate and the cost of the hedging instrument. The Company will also minimize the effect of exchange on monetary assets and liabilities by managing operating activities and net asset positions at the local level.

Foreign currency denominated monetary assets and liabilities are remeasured at spot rates in effect on the balance sheet date with the effects of changes in spot rates reported in *Other (income) expense, net*. The forward contracts are not designated as hedges and are marked to market through *Other (income) expense, net*. Accordingly, fair value changes in the forward contracts help mitigate the changes in the value of the remeasured assets and liabilities attributable to changes in foreign currency exchange rates, except to the extent of the spot-forward differences. These differences are not significant due to the short-term nature of the contracts, which typically have average maturities at inception of less than one year.

When applicable, the Company uses forward contracts to hedge the changes in fair value of certain foreign currency denominated available-for-sale securities attributable to fluctuations in foreign currency exchange rates. These derivative contracts are designated and qualify as fair value hedges. Accordingly, changes in the fair value of the hedged securities due to fluctuations in spot rates are recorded in *Other (income) expense, net*, and offset by the fair value changes in the forward contracts attributable to spot rate fluctuations. Changes in the contracts fair value due to spot-forward differences are excluded from the designated hedge relationship and recognized in *Other (income) expense, net*. These amounts, as well as hedge ineffectiveness, were not significant. The cash flows from these contracts are reported as operating activities in the Consolidated Statement of Cash Flows.

Foreign exchange risk is also managed through the use of foreign currency debt. The Company s senior unsecured euro-denominated notes have been designated as, and are effective as, economic hedges of the net investment in a foreign operation. Accordingly, foreign currency transaction gains or losses on the euro-denominated debt instruments are included in foreign currency translation adjustment within comprehensive income.

Interest Rate Risk Management

At March 31, 2010, the Company was a party to seven pay-floating, receive-fixed interest rate swap contracts designated as fair value hedges of fixed-rate notes in which the notional amounts match the amount of the hedged fixed-rate notes. There are two swaps maturing in 2011 with notional amounts of $125 million each that effectively convert the Company s $250 million, 5.125% fixed-rate notes due 2011 to floating rate instruments and five swaps maturing in 2015 with notional amounts of $150 million each that effectively convert $750 million of the Company s $1.0 billion, 4.0% fixed-rate notes due 2015 to floating rate instruments. The interest rate swap contracts are designated hedges of the fair value changes in the notes attributable to changes in the benchmark

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

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

		March 31, 2010			December 31, 2009		
($ in millions)	Balance Sheet Caption	Fair Value of Derivative Asset		U.S. Dollar Notional	Fair Value of Derivative Asset		U.S. Dollar Notional
			Liability			Liability	
Derivatives Designated as Hedging Instruments							