Zoetis Inc.
Form 10-Q
May 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 March 31, 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 April 27, 2018, there were 483,865,442 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	
(MILLIONS OF DOLLARS AND SHARES, EXCEPT PER SHARE DATA)	March 31, 2018	April 2, 2017
Revenue	$1,366	$1,231
Costs and expenses:		
Cost of sales	447	443
Selling, general and administrative expenses	338	309
Research and development expenses	97	90
Amortization of intangible assets	23	22
Restructuring charges/(reversals) and certain acquisition-related costs	2	(1)
Interest expense, net of capitalized interest	47	41
Other (income)/deductions—net	(5)	(10)
Income before provision for taxes on income	417	337
Provision for taxes on income	67	98
Net income before allocation to noncontrolling interests	350	239
Less: Net (loss)/income attributable to noncontrolling interests	(2)	1
Net income attributable to Zoetis Inc.	$352	$238
Earnings per share attributable to Zoetis Inc. stockholders:		
Basic	$0.72	$0.48
Diluted	$0.72	$0.48
Weighted-average common shares outstanding:		
Basic	485.9	492.4
Diluted	489.8	495.3
Dividends declared per common share	$0.126	$0.105

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	
(MILLIONS OF DOLLARS)	March 31, 2018	April 2, 2017
Net income before allocation to noncontrolling interests	$350	$239
Other comprehensive income, net of taxes and reclassification adjustments:		
Foreign currency translation adjustments, net	77	44
Benefit plans: Actuarial gains, net[(a)]	—	2
Total other comprehensive income, net of tax	77	46
Comprehensive income before allocation to noncontrolling interests	427	285
Less: Comprehensive (loss)/income attributable to noncontrolling interests	(1)	1
Comprehensive income attributable to Zoetis Inc.	$428	$284

(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)	March 31, 2018 (Unaudited)	December 31, 2017
Assets		
Cash and cash equivalents[a]	$ 1,654	$ 1,564
Accounts receivable, less allowance for doubtful accounts of $25 in 2018 and $25 in 2017	943	998
Inventories	1,441	1,427
Other current assets	229	228
Total current assets	4,267	4,217
Property, plant and equipment, less accumulated depreciation of $1,519 in 2018 and $1,471 in 2017	1,453	1,435
Goodwill	1,532	1,510
Identifiable intangible assets, less accumulated amortization	1,280	1,269
Noncurrent deferred tax assets	80	80
Other noncurrent assets	78	75
Total assets	$ 8,690	$ 8,586
Liabilities and Equity		
Accounts payable	$ 217	$ 261
Dividends payable	61	61
Accrued expenses	419	432
Accrued compensation and related items	182	236
Income taxes payable	92	60
Other current liabilities	29	44
Total current liabilities	1,000	1,094
Long-term debt, net of discount and issuance costs	4,954	4,953
Noncurrent deferred tax liabilities	246	380
Other taxes payable	304	172
Other noncurrent liabilities	211	201
Total liabilities	6,715	6,800
Commitments and contingencies (Note 15)		
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; 484,724,245 and 486,130,461 shares outstanding at March 31, 2018, and December 31, 2017, respectively	5	5
Treasury stock, at cost, 17,166,998 and 15,760,782 shares of common stock at March 31, 2018, and December 31, 2017, respectively	(1,005)	(852)
Additional paid-in capital	990	1,013
Retained earnings	2,399	2,109
Accumulated other comprehensive loss	(429)	(505)
Total Zoetis Inc. equity	1,960	1,770
Equity attributable to noncontrolling interests	15	16
Total equity	1,975	1,786
Total liabilities and equity	$ 8,690	$ 8,586

[a] As of both March 31, 2018, and December 31, 2017, includes $6 million of restricted cash.

See notes to condensed consolidated financial statements.

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

	Zoetis						
			Additional		Accumulated Other	Equity Attributable to	
(MILLIONS OF DOLLARS)	Common Stock[a]	Treasury Stock[a]	Paid-in Capital	Retained Earnings	Comprehensive Loss	Noncontrolling Interests	Total Equity
Balance, December 31, 2016	$ 5	$ (421)	$ 1,024	$ 1,477	$ (598)	$ 12	$ 1,499
Three months ended April 2, 2017							
Net income	—	—	—	238	—	1	239
Other comprehensive income	—	—	—	—	46	—	46
Consolidation of a noncontrolling interest[b]	—	—	—	—	—	13	13
Share-based compensation awards[c]	—	36	(10)	(12)	—	—	14
Treasury stock acquired[d]	—	(125)	—	—	—	—	(125)
Employee benefit plan contribution from Pfizer Inc.[e]	—	—	1	—	—	—	1
Dividends declared	—	—	—	(52)	—	—	(52)
Balance, April 2, 2017	$ 5	$ (510)	$ 1,015	$ 1,651	$ (552)	$ 26	$ 1,635
Balance, December 31, 2017	$ 5	$ (852)	$ 1,013	$ 2,109	$ (505)	$ 16	$ 1,786
Three months ended March 31, 2018							
Net income/(loss)	—	—	—	352	—	(2)	350
Other comprehensive income	—	—	—	—	76	1	77
Share-based compensation awards [c]	—	37	(24)	(1)	—	—	12
Treasury stock acquired[d]	—	(190)	—	—	—	—	(190)
Employee benefit plan contribution from Pfizer Inc.[e]	—	—	1	—	—	—	1
Dividends declared	—	—	—	(61)	—	—	(61)
Balance, March 31, 2018	$ 5	$ (1,005)	$ 990	$ 2,399	$ (429)	$ 15	$ 1,975

(a) As of March 31, 2018, and April 2, 2017, there were 484,724,245 and 491,328,479 outstanding shares of common stock, respectively, and 17,166,998 and 10,562,764 shares of treasury stock, respectively. Treasury stock is recognized at the cost to reacquire the shares. For additional information, see Note 13. Stockholders' Equity.

(b) 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 12. Share-Based Payments and Note 13. Stockholders' Equity.

(d) Reflects the acquisition of treasury shares in connection with the share repurchase program. For additional information, see Note 13. 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 11. Benefit Plans.

See notes to condensed consolidated financial statements.

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

	Three Months Ended	
(MILLIONS OF DOLLARS)	March 31, 2018	April 2, 2017
Operating Activities		
Net income before allocation to noncontrolling interests	$350	$239
Adjustments to reconcile net income before noncontrolling interests to net cash provided by operating activities:		
Depreciation and amortization expense	60	62
Share-based compensation expense	11	11
Restructuring	2	(1)
Asset write-offs and asset impairments	2	—
Provision for losses on inventory	16	16
Deferred taxes[(a)]	(141)	24
Employee benefit plan contribution from Pfizer Inc.	1	1
Other non-cash adjustments	3	4
Other changes in assets and liabilities, net of acquisitions and divestitures		
Accounts receivable	60	(22)
Inventories	(33)	(52)
Other assets	(2)	(13)
Accounts payable	(46)	(37)
Other liabilities	(57)	(147)
Other tax accounts, net[(a)]	163	34
Net cash provided by operating activities	389	119
Investing Activities		
Purchases of property, plant and equipment	(53)	(42)
Acquisitions	—	(3)
Net proceeds from sales of assets	8	—
Other investing activities	—	(3)
Net cash used in investing activities	(45)	(48)
Financing Activities		
Payment of contingent consideration related to previously acquired assets	(12)	(5)
Share-based compensation-related proceeds, net of taxes paid on withholding shares	2	6
Purchases of treasury stock	(190)	(125)
Cash dividends paid	(62)	(52)
Net cash used in financing activities	(262)	(176)
Effect of exchange-rate changes on cash and cash equivalents	8	7
Net increase/(decrease) in cash and cash equivalents	90	(98)
Cash and cash equivalents at beginning of period	1,564	727
Cash and cash equivalents at end of period	$1,654	$629
Supplemental cash flow information		
Cash paid during the period for:		
Income taxes	$42	$37
Interest, net of capitalized interest	70	56

Non-cash transactions:		
Purchases of property, plant and equipment	1	4
Contingent purchase price consideration[b]	—	2
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.

(b) For 2017, relates primarily to the consolidation of a European livestock monitoring company a variable interest entity of which Zoetis is the primary beneficiary.

See notes to condensed consolidated financial statements.

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

1. Organization

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

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

2. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements were prepared following the requirements of the Securities and Exchange Commission (SEC) for interim reporting. As permitted under those rules, certain footnotes or other financial information that are normally required by accounting principles generally accepted in the United States of America (U.S. GAAP) can be condensed or omitted. Balance sheet amounts and operating results for subsidiaries operating outside the United States are as of and for the three-month periods ended February 28, 2018, and February 26, 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 7. Tax Matters.

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 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

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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 August 2017, the FASB issued an accounting standards update which amends the hedge accounting recognition and presentation requirements and allows for more hedging strategies to be eligible for hedge accounting. Recognition of periodic hedge effectiveness will no longer be required for cash flow and net investment hedges and companies may elect to perform subsequent hedge effectiveness assessments qualitatively. The update also clarifies that the change in fair value of a derivative must be recorded in the same income statement line item as the earnings effect of the hedged item and introduces additional disclosure requirements including cumulative basis adjustments for fair value hedges and the effect of hedging on individual income statement line items. 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 as well as the potential impact that the standard will have 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 and are currently evaluating 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 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 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.

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

Revenue by geographic area

(MILLIONS OF DOLLARS)	Three Months Ended March 31, 2018	April 2, 2017
United States	$634	$605
Australia	48	40
Brazil	70	66
Canada	40	34
China	64	52
France	33	29
Germany	38	28
Italy	27	22
Japan	41	34
Mexico	24	18
Spain	25	20
United Kingdom	52	43
Other developed markets	79	68
Other emerging markets	185	161
	1,360	1,220
Contract Manufacturing	6	11
Total Revenue	$1,366	$1,231

Revenue by major species

(MILLIONS OF DOLLARS)	Three Months Ended March 31, 2018	April 2, 2017
U.S.		
Livestock	$292	$282
Companion Animal	342	323
	634	605
International		
Livestock	478	421
Companion Animal	248	194
	726	615
Contract Manufacturing	6	11
Total Revenue	$1,366	$1,231

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Revenue by species

	Three Months Ended	
(MILLIONS OF DOLLARS)	March 31, 2018	April 2, 2017
Livestock:		
Cattle	$416	$386
Swine	175	160
Poultry	136	116
Fish	22	21
Other	21	20
	770	703
Companion Animal:		
Dogs and Cats	549	482
Horses	41	35
	590	517
Contract Manufacturing	6	11
Total Revenue	$1,366	$1,231

Revenue by major product category

	Three Months Ended	
(MILLIONS OF DOLLARS)	March 31, 2018	April 2, 2017
Vaccines	$356	$319
Anti-infectives	297	268
Other pharmaceuticals	319	272
Parasiticides	191	184
Medicated feed additives	137	123
Other non-pharmaceuticals	60	54
	1,360	1,220
Contract Manufacturing	6	11
Total Revenue	$1,366	$1,231

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 quarter of 2018 were approximately $2 million. Contract liabilities as of March 31, 2018 were approximately $4 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 March 31, 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. 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. As part of these initiatives, we planned to reduce certain positions through divestitures, normal attrition and involuntary terminations by approximately 2,800, subject to consultations with works councils and unions in certain countries. Including divestitures, as of March 31, 2018, approximately 2,600 positions have been eliminated related to these initiatives. 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	
(MILLIONS OF DOLLARS)	March 31, 2018	April 2, 2017
Restructuring charges/(reversals) and certain acquisition-related costs:		
Integration costs[a]	$1	$—
Restructuring charges/(reversals)[b][c]:		

Employee termination costs/(reversals)	1	(1)
Total Restructuring charges/(reversals) and certain acquisition-related costs	$2	$(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/(reversals) for the three months ended March 31, 2018, primarily relate to the supply network strategy.

The restructuring charges/(reversals) for the three months ended April 2, 2017, primarily relate to the operational efficiency initiative.

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

- For the three months ended March 31, 2018, Manufacturing/research/corporate ($1 million).
- For the three months ended April 2, 2017, U.S. ($1 million) and International ($2 million reversal).

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

(MILLIONS OF DOLLARS)	Three Months Ended March 31, 2018	April 2, 2017
Restructuring charges/(reversals) and certain acquisition-related costs:		
Operational efficiency initiative		
Employee termination costs	$—	$(1)
	—	(1)
Supply network strategy:		
Employee termination costs	1	—
	1	—
Total restructuring charges/(reversals) related to the operational efficiency initiative and supply network strategy	1	(1)
Other supply network strategy charges		
Cost of sales:		
Accelerated depreciation	—	1
Consulting fees	1	2
Total other supply network strategy charges	1	3
Total charges associated with the operational efficiency initiative and supply network strategy	$2	$2

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

(MILLIONS OF DOLLARS)	Accrual[(a)]
Balance, December 31, 2017[(b)]	$ 41
Provision	1
Utilization and other[(c)]	(7)
Balance, March 31, 2018[(b)]	$ 35

(a) Changes in our restructuring accruals represent employee termination costs.

(b) At March 31, 2018, and December 31, 2017, included in Accrued expenses ($14 million and $19 million, respectively) and Other noncurrent liabilities ($21 million and $22 million, respectively).

(c) Includes adjustments for foreign currency translation.

6. Other (Income)/Deductions—Net

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

(MILLIONS OF DOLLARS)	Three Months Ended March 31, 2018	April 2, 2017
Royalty-related income	$(7)	$(7)
Foreign currency loss[(a)]	8	2
Other, net[(b)]	(6)	(5)
Other (income)/deductions—net	$(5)	$(10)

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

(b) For the three months ended March 31, 2018, primarily includes interest income and other miscellaneous income. For the three months ended April 2, 2017, primarily includes a settlement refund and reimbursement of legal fees related to costs incurred by Pharmaq prior to the acquisition in 2015, as well as interest income and other miscellaneous income.

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7. 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, we were able to further refine our initial reasonable estimate and adjusted the initial provisional net tax expense of $212 million and recorded the following measurement-period adjustments during the first quarter of 2018:

- One-Time Mandatory Deemed Repatriation Tax: The one-time mandatory deemed repatriation tax is a tax 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 E&P computations that were calculated during the reporting period, we recognized a measurement-period adjustment of $2 million 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 first quarter 2018 effective tax rate was a reduction to the rate of approximately 0.6%. 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 quarter 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.
- 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 quarter 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 16.1% for the three months ended March 31, 2018, compared with 29.1% for the three months ended April 2, 2017. The lower effective tax rate for the three months ended March 31, 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;
- 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 $5 million discrete tax benefit recorded in the first quarter of 2018 and 2017, respectively, related to the excess tax benefits for share-based payments;

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- an $8 million and $3 million discrete tax benefit recorded in the first quarter 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; and
- a $2 million net discrete tax benefit recorded in the first 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.

B. Deferred Taxes

As of March 31, 2018, the total net deferred income tax liability of $166 million is included in Noncurrent deferred tax assets ($80 million) and Noncurrent deferred tax liabilities ($246 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 March 31, 2018, the tax liabilities associated with uncertain tax positions of $191 million (exclusive of interest and penalties related to uncertain tax positions of $12 million) are included in Noncurrent deferred tax assets ($4 million) and Other taxes payable ($187 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 based on estimates and assumptions that have been deemed reasonable by management, but our estimates of uncertain tax positions and potential tax benefits may not be representative of actual outcomes, and any variation from such estimates could materially affect our financial statements in the period of settlement or when the statutes of limitations expire, as we treat these events as discrete items in the period of resolution. Finalizing audits with the relevant taxing authorities can include formal administrative and legal proceedings, and, as a result, it is difficult to estimate the timing and range of possible changes related to our uncertain tax positions, and such changes could be significant.

8. Financial Instruments

A. Debt

Credit Facilities

In December 2016, we entered into an amended and restated revolving credit agreement with a syndicate of banks providing for a five-year $1.0 billion senior unsecured revolving credit facility (the credit facility). 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 $