Zoetis Inc.
Form 10-Q
August 14, 2013
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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, 2013
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.)
100 Campus Drive, Florham Park, New Jersey	07932
(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 or a smaller reporting company. See definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x 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 x No
At August 9, 2013, there were 500,000,000 shares of common stock outstanding.

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PART I – FINANCIAL INFORMATION
Item 1. Financial Statements

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

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS AND SHARES, EXCEPT PER SHARE DATA)	June 30, 2013	July 1, 2012	June 30, 2013	July 1, 2012
Revenue	$1,114	$1,094	$2,204	$2,141
Costs and expenses:				
Cost of sales[(a)]	416	378	818	771
Selling, general and administrative expenses[(a)]	399	344	756	682
Research and development expenses[(a)]	95	92	185	194
Amortization of intangible assets[(a)]	15	16	30	32
Restructuring charges and certain acquisition-related costs	(20)	24	(13)	49
Interest expense	32	8	54	16
Other (income)/deductions—net	(10)	(20)	(5)	(26)
Income before provision for taxes on income	187	252	379	423
Provision for taxes on income	59	79	111	138
Net income before allocation to noncontrolling interests	128	173	268	285
Less: Net income attributable to noncontrolling interests	—	—	—	1
Net income attributable to Zoetis Inc.	$128	$173	$268	$284
Earnings per share attributable to Zoetis Inc. stockholders:				
Basic	$0.26	$0.35	$0.54	$0.57
Diluted	$0.26	$0.35	$0.54	$0.57
Weighted-average common shares outstanding:				
Basic	500.000	500.000	500.000	500.000
Diluted	500.217	500.000	500.164	500.000
Dividends declared per common share	$0.065	$—	$0.130	$—

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

See notes to condensed consolidated and combined financial statements.

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

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	June 30, 2013	July 1, 2012	June 30, 2013	July 1, 2012
Net income before allocation to noncontrolling interests	$128	$173	$268	$285
Other comprehensive income/(loss), net of taxes and reclassification adjustments[(a)]:				
Foreign currency translation adjustments, net	(33)	(162)	(17)	(128)
Benefit plans: Actuarial losses, net	(1)	—	(3)	—
Total other comprehensive income/(loss), net of tax	(34)	(162)	(20)	(128)
Comprehensive income before allocation to noncontrolling interests	94	11	248	157
Less: Comprehensive income attributable to noncontrolling interests	—	—	—	1
Comprehensive income attributable to Zoetis Inc.	$94	$11	$248	$156

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

See notes to condensed consolidated and combined financial statements.

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ZOETIS INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED AND COMBINED BALANCE SHEETS

(MILLIONS OF DOLLARS AND SHARES, EXCEPT PER SHARE DATA)	June 30, 2013[a] (Unaudited)	December 31, 2012[a]
Assets		
Cash and cash equivalents	$369	$317
Accounts receivable, less allowance for doubtful accounts of $34 in 2013 and $49 in 2012	1,137	900
Inventories	1,257	1,345
Current deferred tax assets	92	101
Other current assets	227	201
Total current assets	3,082	2,864
Property, plant and equipment, less accumulated depreciation of $974 in 2013 and $1,011 in 2012	1,252	1,241
Goodwill	982	985
Identifiable intangible assets, less accumulated amortization	834	868
Noncurrent deferred tax assets	54	216
Other noncurrent assets	57	88
Total assets	$6,261	$6,262
Liabilities and Equity		
Short-term borrowings, including current portion of allocated long-term debt in 2012	$12	$73
Accounts payable	587	319
Accrued compensation and related items	157	194
Income taxes payable	83	30
Dividends payable	33	—
Other current liabilities	449	507
Total current liabilities	1,321	1,123
Long-term debt	3,640	—
Allocated long-term debt	—	509
Noncurrent deferred tax liabilities	308	323
Other taxes payable	38	159
Other noncurrent liabilities	131	107
Total liabilities	5,438	2,221
Commitments and contingencies		
Business unit equity	—	4,183
Stockholders' equity:		
Common stock, $0.01 par value: 5,000 authorized, 500 issued and outstanding	5	—
Additional paid-in capital	869	—
Retained earnings	109	—
Accumulated other comprehensive loss	(183)	(157)
Total Zoetis Inc. equity	800	4,026
Equity attributable to noncontrolling interests	23	15
Total equity	823	4,041
Total liabilities and equity	$6,261	$6,262

[a] The condensed consolidated balance sheet as of June 30, 2013 has been prepared under a different basis of presentation than the condensed combined

balance sheet as of December 31, 2012, which significantly impacts comparability. See Note 3. Basis of Presentation.

See notes to condensed consolidated and combined financial statements.

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

(MILLIONS OF DOLLARS)	Zoetis Business Unit Equity[a]	Common Stock[b]	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Equity Attributable to Noncontrolling Interests	Total Equity
Balance, December 31, 2011	$3,785	$—	$ —	$—	$ (65)	$ 16	$3,736
Six months ended July 1, 2012							
Comprehensive income	284	—	—	—	(128)	1	157
Share-based compensation expense	12	—	—	—	—	—	12
Dividends declared and paid	(62)	—	—	—	—	—	(62)
Net transfers between Pfizer Inc. and noncontrolling interests	1	—	—	—	—	(1)	—
Net transfers—Pfizer Inc.	88	—	—	—	—	—	88
Balance, July 1, 2012	$4,108	$—	$ —	$—	$ (193)	$ 16	$3,931
Balance, December 31, 2012	$4,183	$—	$ —	$—	$ (157)	$ 15	$4,041
Six months ended June 30, 2013							
Comprehensive income	94	—	—	174	(20)	—	248
Share-based compensation expense	3	—	28	—	—	—	31
Net transfers—Pfizer Inc.	(271)	—	—	—	—	—	(271)
Separation adjustments[c]	414	—	34	—	(6)	8	450
Employee benefit plan contribution from Pfizer Inc.[d]	—	—	—	—	—	—	—
Reclassification of net liability due to Pfizer Inc.[e]	(60)	—	—	—	—	—	(60)
Consideration paid to Pfizer Inc. in connection with the Separation[f]	—	—	(3,551)	—	—	—	(3,551)
Issuance of common stock to Pfizer Inc. in connection with the Separation and reclassification of Business Unit Equity[f]	(4,363)	5	4,358	—	—	—	—
Dividends declared	—	—	—	(65)	—	—	(65)
Balance, June 30, 2013	$—	$5	$ 869	$109	$ (183)	$ 23	$823

(a) All amounts associated with Business Unit Equity relate to periods prior to the Separation. See Note 2A. The Separation, Adjustments Associated with the Separation, Senior Notes Offering, Initial Public Offering and Exchange Offer: The Separation.

(b) As of June 30, 2013, there were 500,000,000 outstanding shares of common stock.

(c)

For additional information, see Note 2B. The Separation, Adjustments Associated with the Separation, Senior Notes Offering, Initial Public Offering and Exchange Offer: Adjustments Associated with the Separation.

(d) Represents contributed capital from Pfizer Inc. associated with service credit continuation for certain Zoetis Inc. employees in Pfizer Inc.'s U.S. qualified defined benefit and U.S. retiree medical plans. See Note 12. Benefit Plans.

(e) Represents the reclassification of the Receivable from Pfizer Inc. and the Payable to Pfizer Inc. from Business Unit Equity as of the Separation date. See Note 2A. The Separation, Adjustments Associated with the Separation, Senior Notes Offering, Initial Public Offering and Exchange Offer: The Separation.

(f) Reflects the Separation transaction. See Note 2A. The Separation, Adjustments Associated with the Separation, Senior Notes Offering, Initial Public Offering and Exchange Offer: The Separation.

See notes to condensed consolidated and combined financial statements.

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

	Six Months Ended	
(MILLIONS OF DOLLARS)	June 30, 2013	July 1, 2012
Operating Activities		
Net income before allocation to noncontrolling interests	$268	$285
Adjustments to reconcile net income before noncontrolling interests to net cash provided by operating activities:		
Depreciation and amortization expense	102	102
Share-based compensation expense	31	12
Asset write-offs and asset impairments	3	6
Deferred taxes	(19)	(26)
Other non-cash adjustments	(1)	(3)
Other changes in assets and liabilities, net of acquisitions and divestitures and transfers with Pfizer Inc.	(115)	(306)
Net cash provided by operating activities	269	70
Investing Activities		
Purchases of property, plant and equipment	(80)	(55)
Acquisitions, net of cash acquired	—	(1)
Cash proceeds from the sale of property, plant and equipment	6	—
Other investing activities	—	(3)
Net cash used in investing activities	(74)	(59)
Financing Activities		
Increase in short-term borrowings, net	12	—
Proceeds from issuance of long-term debt—senior notes, net of discount and fees	2,624	—
Consideration paid to Pfizer Inc. in connection with the Separation[a]	(2,559)	—
Cash dividends paid[b]	(33)	(62)
Other net financing activities with Pfizer Inc.	(184)	80
Net cash (used in)/provided by financing activities	(140)	18
Effect of exchange-rate changes on cash and cash equivalents	(3)	(2)
Net increase in cash and cash equivalents	52	27
Cash and cash equivalents at beginning of period	317	79
Cash and cash equivalents at end of period	$369	$106
Supplemental cash flow information		
Cash paid during the period for:		
Income taxes	$26	$147
Interest	—	23
Non-cash transactions:		
Dividends declared, not paid	$33	$—
Zoetis Inc. senior notes transferred to Pfizer Inc. in connection with the Separation[c]	992	—

(a) Reflects the Separation transaction. Amount is net of the non-cash portion. See Note 2A. The Separation, Adjustments Associated with the Separation, Senior Notes Offering, Initial Public Offering and Exchange Offer: The Separation.

(b) Payments to other non-Zoetis Pfizer Inc. entities for the six months ended July 1, 2012.

(c)

Reflects the non-cash portion of the Separation transaction. See Note 2A. The Separation, Adjustments Associated with the Separation, Senior Notes Offering, Initial Public Offering and Exchange Offer: The Separation.

See notes to condensed consolidated and combined financial statements.

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

1. Organization

Zoetis Inc. (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 four geographic regions: the United States (U.S.); Europe/Africa/Middle East (EuAfME); Canada/Latin America (CLAR); and Asia/Pacific (APAC).

We market our products in more than 120 countries, including developed markets and emerging markets. Our revenues are mostly generated in the U.S. and EuAfME. 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. The Separation, Adjustments Associated with the Separation, Senior Notes Offering, Initial Public Offering and Exchange Offer

Pfizer Inc. (Pfizer) formed Zoetis to acquire, own and operate the animal health business of Pfizer. On June 24, 2013, Pfizer completed an exchange offer resulting in the full separation of Zoetis from Pfizer. For additional information see E. Exchange Offer.

A. The Separation

In the first quarter of 2013, through a series of steps (collectively, the Separation), Pfizer transferred to us its subsidiaries holding substantially all of the assets and liabilities of its animal health business. In exchange, we transferred to Pfizer: (i) all of the issued and outstanding shares of our Class A common stock; (ii) all of the issued and outstanding shares of our Class B common stock; (iii) $1.0 billion in senior notes (see "Senior Notes Offering" below); and (iv) an amount of cash equal to substantially all of the net proceeds received in the senior notes offering (approximately $2.5 billion).

B. Adjustments Associated with the Separation

In connection with the Separation, certain animal health assets and liabilities included in the pre-Separation balance sheet were retained by Pfizer and certain non-animal health assets and liabilities (not included in the pre-Separation balance sheet) were transferred to Zoetis. The adjustments to the historical balance sheet of Zoetis (collectively, the Separation Adjustments) representing approximately $450 million of net liabilities retained by Pfizer, were primarily related to the following:

- The removal of inventories (approximately $74 million), property, plant and equipment (approximately $28 million) and miscellaneous other net liabilities (approximately $21 million) associated with certain non-dedicated manufacturing sites that were retained by Pfizer;
- The addition of property, plant and equipment (approximately $56 million) associated with a non-dedicated manufacturing site that was transferred to us by Pfizer (and then leased back to Pfizer under operating leases), and the removal of the inventory (approximately $46 million) and net other assets (approximately $4 million) at that site as these assets were retained by Pfizer;
- The addition of net benefit plan liabilities (approximately $25 million);
- The elimination of (i) noncurrent deferred tax assets (some of which were included within noncurrent deferred tax liabilities due to jurisdictional netting) related to net operating loss and tax credit carryforwards; (ii) net tax liabilities associated with uncertain tax positions; (iii) noncurrent deferred tax liabilities related to deferred income taxes on unremitted earnings; and (iv) other allocated net tax assets, all of which (approximately $49 million in net tax asset accounts) were retained by Pfizer;
- The addition of (i) noncurrent deferred tax assets (approximately $8 million, some of which were included within noncurrent deferred tax liabilities due to jurisdictional netting) related to net benefit plan liabilities transferred to us by Pfizer; (ii) noncurrent deferred tax assets (approximately $2 million) related to net operating loss and tax credit carryforwards; and (iii) noncurrent deferred tax liabilities (approximately $2 million) related to property, plant and equipment transferred to us by Pfizer;

- The elimination of allocated long-term debt (approximately $582 million), allocated accrued interest payable (approximately $16 million) and allocated unamortized deferred debt issuance costs (approximately $2 million) that were retained by Pfizer;
- Certain net financial assets retained by Pfizer (approximately $45 million);
- The removal of cash (approximately $7 million), inventories (approximately $5 million), property plant and equipment (approximately $8 million), miscellaneous other assets (approximately $3 million) and other miscellaneous liabilities (approximately $2 million) associated with non-U.S. Pfizer businesses that did not transfer to us from Pfizer;
- The addition of net receivables from Pfizer (approximately $5 million) associated with certain foreign taxes directly resulting from certain aspects of the Separation that were the responsibility of Pfizer under the terms of the tax matters agreement, see Note 7B. Income Taxes: Tax Matters Agreement;

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- The addition of (i) inventory (approximately $15 million); (ii) net deferred tax assets (approximately $1 million); and (iii) miscellaneous other assets (approximately $5 million) transferred to us by Pfizer, and the removal of (i) property, plant and equipment (approximately $2 million); (ii) miscellaneous other liabilities (approximately $57 million), and (iii) the elimination of prepaid taxes (approximately $4 million) that were retained by Pfizer;
- The addition of net benefit plan liabilities (approximately $16 million) associated with certain international plans that will be transferred from Pfizer to Zoetis in 2014. See Note 12. Benefit Plans.

The Separation Adjustment associated with Accumulated Other Comprehensive Income reflects the accumulated currency translation adjustment based on the actual legal entity structure of Zoetis.

C. Senior Notes Offering

In connection with the Separation, on January 28, 2013, we issued $3.65 billion aggregate principal amount of our senior notes (the senior notes offering) in a private placement, with an original issue discount of $10 million. For additional information, see Note 9D. Financial Instruments: Senior Notes Offering.

D. Initial Public Offering (IPO)

After the Separation, on February 6, 2013, an IPO of 99,015,000 shares of our Class A common stock (including the exercise of the underwriters' over-allotment option) at a price of $26.00 per share was completed. Pfizer retained the net proceeds from the IPO.

Immediately following the IPO, there were 99,015,000 outstanding shares of Class A common stock and 400,985,000 outstanding shares of Class B common stock. The rights of the holders of Class A common stock and Class B common stock are identical, except with respect to voting and conversion rights. Following the IPO, Pfizer owned all of the outstanding shares of our Class B Common Stock, all of which was converted to Class A common stock in connection with the Exchange Offer. See E. Exchange Offer. There are no longer any shares of our Class B Common Stock outstanding.

In connection with the IPO, we entered into certain agreements that provide a framework for an ongoing relationship with Pfizer. For additional information, see Note 17B. Transactions and Agreements with Pfizer: Agreements with Pfizer.

E. Exchange Offer

On May 22, 2013, Pfizer announced an exchange offer whereby Pfizer shareholders could exchange a portion of Pfizer common stock for Zoetis common stock. The exchange offer was completed on June 24, 2013, resulting in the full separation of Zoetis and the disposal of Pfizer's entire ownership and voting interest in Zoetis.

3. Basis of Presentation

The accompanying unaudited condensed consolidated and combined 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 U.S. are as of and for the three and six-month periods ended May 26, 2013 and May 27, 2012.

Revenues, 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 and combined financial statements included in this Form 10-Q. The condensed consolidated and combined 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 combined financial statements and accompanying notes included in the Company’s 2012 Annual Report on Form 10-K.

A. Basis of Presentation Prior to the Separation

Prior to the Separation, the combined financial statements were derived from the consolidated financial statements and accounting records of Pfizer and included allocations for direct costs and indirect costs attributable to the operations of the animal health business of Pfizer. The pre-Separation financial statements and activities do not purport to reflect what the results of operations, comprehensive income/(loss), financial position, equity or cash flows would have been had we operated as a standalone public company during the period presented.

- The condensed combined statements of income for the three and six months ended July 1, 2012 and the pre-Separation period in the condensed consolidated statement of income include allocations from certain support functions (Enabling Functions) that are provided on a centralized basis within Pfizer, such as expenses for business technology, facilities, legal, finance, human resources, and, to a lesser extent, business development, public affairs and procurement, among others, as Pfizer does not routinely allocate these costs to any of its business units. These allocations are based on either a specific identification basis or, when specific identification is not practicable, proportional allocation methods (e.g., using third-party sales, headcount, etc.), depending on the nature of the services.

Costs associated with business technology, facilities and human resources were allocated primarily using proportional allocation methods and, for legal and finance, primarily using specific identification. In all cases, for support function costs where proportional allocation methods were used, we determined whether the costs are primarily influenced by headcount (such as a significant majority of facilities and human resources costs) or by the size of the business (such as most business technology costs), and we also

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determined whether the associated scope of those services provided are global, regional or local. Based on those analyses, the costs were allocated based on our share of worldwide revenues, domestic revenues, international revenues, regional revenues, country revenues, worldwide headcount, country headcount or site headcount, as appropriate.

As a result, costs associated with business technology and legal that were not specifically identified were mostly allocated based on revenue drivers and, to a lesser extent, based on headcount drivers; costs associated with finance that were not specifically identified were all allocated based on revenue drivers; and costs associated with facilities and human resources that were not specifically identified were predominantly allocated based on headcount drivers.

- The condensed combined statement of income for the three and six months ended July 1, 2012 and the pre-Separation period in the condensed consolidated statement of income include allocations of certain manufacturing and supply costs incurred by manufacturing plants that are shared with other Pfizer business units, Pfizer's global external supply group and Pfizer's global logistics and support group (collectively, Pfizer Global Supply, or PGS). These costs may include manufacturing variances and changes in the standard costs of inventory, among others, as Pfizer does not routinely allocate these costs to any of its business units. These allocations are based on either a specific identification basis or, when specific identification is not practicable, proportional allocation methods, such as animal health identified manufacturing costs, depending on the nature of the costs.
- The condensed combined statement of income for the three and six months ended July 1, 2012 and the pre-Separation period in the condensed consolidated statement of income also include allocations from the Enabling Functions and PGS for restructuring charges, integration costs, additional depreciation associated with asset restructuring and implementation costs, as Pfizer does not routinely allocate these costs to any of its business units. For additional information about allocations of restructuring charges and other costs associated with acquisitions and cost-reduction/productivity initiatives, see Note 5. Restructuring Charges and Other Costs Associated with Acquisitions and Cost-Reduction/Productivity Initiatives.
- The condensed combined statement of income for the three and six months ended July 1, 2012 and the pre-Separation period in the condensed consolidated statement of income include an allocation of share-based compensation expense and certain other compensation expense items, such as certain fringe benefit expenses, maintained on a centralized basis within Pfizer, as Pfizer does not routinely allocate these costs to any of its business units. For additional information about allocations of share-based payments, see Note 13. Share-Based Payments.
- The condensed combined balance sheet as of December 31, 2012 reflects all of the assets and liabilities of Pfizer that are either specifically identifiable or are directly attributable to Zoetis and its operations. For benefit plans, the combined balance sheets only include the assets and liabilities of benefit plans dedicated to animal health employees. For debt, see below.
- The condensed combined balance sheet as of December 31, 2012 includes an allocation of long-term debt from Pfizer that was issued to partially finance the acquisition of Wyeth (including Fort Dodge Animal Health (FDAH)). The debt and associated interest-related expenses, including the effect of hedging activities, have been allocated on a pro-rata basis using the deemed acquisition cost of FDAH as a percentage of the total acquisition cost of Wyeth. No other allocations of debt have been made as none are specifically related to our operations.

The allocated expenses from Pfizer include the items noted below for the pre-Separation period in 2013 and the first six months of 2012.

- Enabling Functions operating expenses—$11 million in 2013 and $152 million in 2012 ($1 million in Cost of sales in 2012; $11 million and $123 million in Selling, general and administrative expenses in 2013 and 2012, respectively; and $28 million in Research and development expenses in 2012).
- PGS manufacturing costs—approximately $12 million in 2012 (in Cost of sales).
- Restructuring charges and certain acquisition-related costs—$35 million in 2012 (in Restructuring charges and certain acquisition-related costs).
- Other costs associated with cost reduction/productivity initiatives—additional depreciation associated with asset restructuring—$2 million in 2013 (in Selling, general and administrative expenses) and $9 million in 2012 (in Research and development expenses).

Other costs associated with cost reduction/productivity initiatives—implementation costs—$1 million in 2013 and $2 million in 2012 (in Selling, general and administrative expenses).

- Share-based compensation expense—approximately $3 million in 2013 and $17 million in 2012 ($1 million and $3 million in Cost of sales in 2013 and 2012, respectively; $2 million and $11 million in Selling, general and administrative expenses in 2013 and 2012, respectively; and $3 million in Research and development expenses in 2012).
- Compensation-related expenses—approximately $1 million in 2013 and $11 million in 2012 ($3 million in Cost of sales in 2012; $1 million and $5 million in Selling, general and administrative expenses in 2013 and 2012, respectively; and $3 million in Research and development expenses in 2012).
- Interest expense—approximately $2 million in 2013 and $16 million in 2012.

The income tax provision in the condensed combined statement of income was calculated as if Zoetis filed a separate return.

Management believes that the allocations are a reasonable reflection of the services received or the costs incurred on behalf of Zoetis and its operations and that the condensed combined statement of income for the three and six months ended ended July 1, 2012 and the pre-Separation period in the condensed consolidated statement of income for the six months ended June 30, 2013.

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Prior to the Separation, we participated in Pfizer's centralized cash management system and generally all excess cash was transferred to Pfizer on a daily basis. Cash disbursements for operations and/or investing activities were funded as needed by Pfizer. We had also participated in Pfizer's centralized hedging and offsetting programs. As such, in the combined statement of income for the three and six months ended July 1, 2012, we include the impact of Pfizer's derivative financial instruments used for offsetting changes in foreign currency rates, net of the related foreign exchange gains and losses for the portion that is deemed to be associated with the animal health operations. Such gains and losses were not material to the combined financial statement for the periods presented.

As of December 31, 2012, all balances and transactions among Zoetis and Pfizer and its subsidiaries, which can include dividends as well as other activities, are shown in Business unit equity in the combined balance sheet. As the books and records of Zoetis were not kept on a separate company basis, the determination of the average net balance due to or from Pfizer is not practicable.

B. Basis of Presentation After the Separation

The unaudited condensed consolidated financial statements as of and for the three and six months ended June 30, 2013 comprise the following: (i) the results of operations, comprehensive income, and cash flow amounts for the period prior to the Separation (see above), which includes allocations for direct costs and indirect costs attributable to the operations of the animal health business; and (ii) the amounts for the period after the Separation, which reflect the results of operations, comprehensive income, financial position, equity and cash flows resulting from our operation as a standalone public company.

The income tax provision prepared after the Separation is based on the actual legal entity structure of Zoetis, with certain accommodations pursuant to a tax matters agreement. For additional information, see Note 17B. Transactions and Agreements with Pfizer: Agreements with Pfizer.

4. Significant Accounting Policies

A. New Accounting Standards

There were no new accounting standards adopted during the first half of 2013.

B. Fair Value

Our fair value methodologies depend on the following types of inputs:

- Quoted prices for identical assets or liabilities in active markets (Level 1 inputs).
- Quoted prices for similar assets or liabilities in active markets or quoted prices for identical or similar assets or liabilities in markets that are not active or are directly or indirectly observable (Level 2 inputs).
- Unobservable inputs that reflect estimates and assumptions (Level 3 inputs).

A single estimate of fair value can result from a complex series of judgments about future events and uncertainties and can rely heavily on estimates and assumptions.

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

We incurred significant costs in connection with Pfizer’s cost-reduction initiatives (several programs initiated since 2005), and the acquisitions of Fort Dodge Animal Health (FDAH) on October 15, 2009 and King Animal Health (KAH) on January 31, 2011.

For example:

- in connection with the 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; and
- 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, 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, as well as functions such as business technology, shared services and corporate operations.

In the fourth quarter of 2012, when we were a business unit of Pfizer, we announced a restructuring plan related to our operations in Europe. In connection with these actions, we recorded a pre-tax charge of $27 million to recognize employee termination costs. As a result of becoming a standalone public company (no longer being a majority owned

subsidiary of Pfizer) and related economic consideration, we revisited this restructuring action and decided to no longer implement this restructuring plan. As such, we reversed the existing reserve of $27 million in the second quarter of 2013.

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The components of costs incurred in connection with our acquisitions and restructuring initiatives follow:

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	June 30, 2013	July 1, 2012	June 30, 2013	July 1, 2012
Restructuring charges and certain acquisition-related costs:				
Integration costs[a]	$10	$5	$14	$9
Restructuring charges (benefits)[b]:				
Employee termination costs	(30)	1	(27)	3
Asset impairment charges	—	1	—	1
Exit costs	—	—	—	1
Total direct	(20)	7	(13)	14
Integration costs[a]	—	7	—	12
Restructuring charges[b]:				
Employee termination costs	—	9	—	14
Asset impairment charges	—	1	—	8
Exit costs	—	—	—	1
Total allocated	—	17	—	35
Total Restructuring charges and certain acquisition-related costs	(20)	24	(13)	49
Other costs associated with cost-reduction/productivity initiatives:				
Additional depreciation associated with asset restructuring—direct[c]	1	2	1	5
Additional depreciation associated with asset restructuring—allocated[c]	—	—	2	9
Implementation costs—allocated[d]	—	1	1	2
Total costs associated with acquisitions and cost-reduction/productivity initiatives	$(19)	$27	$(9)	$65

(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.

(b) The restructuring benefit for the three and six months ended June 30, 2013 is related to the reversal of certain employee termination expenses associated with our operations in Europe and the restructuring charges for the three and six months July 1, 2012 are primarily related to the integration of FDAH and KAH.

The direct charges are associated with the following:

- For the three months ended June 30, 2013— Manufacturing/research/corporate ($30 million income).
- For the six months ended June 30, 2013— Manufacturing/research/corporate ($27 million income).
- For the three months ended July 1, 2012—U.S. ($3 million), EuAfME ($1 million), and manufacturing/research/corporate ($2 million income).
- For the six months ended July 1, 2012—U.S. ($3 million), EuAfME ($1 million income), CLAR ($1 million), and manufacturing/research/corporate ($2 million).

(c) Additional depreciation associated with asset restructuring represents the impact of changes in the estimated lives of assets involved in restructuring actions. For the three months ended June 30, 2013, included in Cost of sales ($1 million). For the six months ended June 30, 2013, included in Cost of sales ($1 million) and Selling, general and administrative expenses ($2 million). For the three months ended July 1, 2012, included in Cost of sales ($2 million). For the six months ended July 1, 2012, included in Cost of sales ($5 million) and Research and development expenses ($9 million).

(d) Implementation costs—allocated represent external, incremental costs directly related to implementing cost reduction/productivity initiatives, and primarily include expenditures related to system and process standardization

and the expansion of shared services. Included in Selling, general and administrative expenses.

The components of and changes in our direct restructuring accruals follow:

(MILLIONS OF DOLLARS)	Employee Termination Costs	Asset Impairment Charges	Exit Costs	Accrual
Balance, December 31, 2012[a]	$ 68	$—	$6	$74
Provision/(Benefit)	(27)	—	—	(27)
Utilization and other[b]	(10)	—	(5)	(15)
Separation adjustment[c]	(14)	—	—	(14)
Balance, June 30, 2013[a]	$ 17	$—	$1	$18

(a) At June 30, 2013 and December 31, 2012, included in Other current liabilities ($9 million and $63 million, respectively) and Other noncurrent liabilities ($9 million and $11 million, respectively).

(b) Includes adjustments for foreign currency translation.

(c) See Note 2B. The Separation, Adjustments Associated with the Separation, Senior Notes Offering, Initial Public Offering and Exchange Offer: Adjustments Associated with the Separation.

6. Other (Income)/Deductions—Net

The components of Other (income)/deductions—net follow:

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	June 30, 2013	July 1, 2012	June 30, 2013	July 1, 2012
Royalty-related income	$(5)	$(7)	$(13)	$(13)
Identifiable intangible asset impairment charges	—	3	1	3
Net gain on sale of assets[a]	(6)	—	(6)	—
Certain legal matters, net[b]	—	(19)	—	(19)
Foreign currency loss[c]	2	3	12	3
Other, net	(1)	—	1	—
Other (income)/deductions—net	$(10)	$(20)	$(5)	$(26)

(a) For the three and six months ended June 30, 2013, represents the net gain on the government-mandated sale of certain product rights in Brazil that were acquired with the FDAH acquisition in 2009.

(b) For the three and six months ended July 1, 2012, represents income from a favorable legal settlement related to an intellectual property matter ($14 million) and a change in estimate for an environmental-related reserve due to a favorable settlement ($7 million) partially offset by litigation-related charges ($2 million).

(c) For the six months ended June 30, 2013, primarily related to the Venezuela currency devaluation in February 2013.

7. Income Taxes

A. Taxes on Income

The effective tax rate was 31.6% for the second quarter of 2013, compared to 31.3% for the second quarter of 2012. The higher effective tax rate was primarily due to the impact of the non-deductibility and jurisdictional mix of certain costs incurred during the quarter related to becoming a standalone public company, partially offset by:

- incentive tax rulings in Belgium, effective December 31, 2012, and Singapore, effective October 29, 2012, and
- changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings as well as repatriation costs.

The effective tax rate was 29.3% for the first six months of 2013, compared to 32.6% for the first six months of 2012. The lower effective tax rate was primarily attributable to:

- the aforementioned incentive tax rulings and changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings as well as repatriation costs, and
- a $2 million discrete income tax benefit during the first quarter of 2013 related to the 2012 U.S. research and development tax credit which was retroactively extended on January 3, 2013;

partially offset by:

- the aforementioned impact of non-deductibility and jurisdictional mix of certain costs incurred during the second quarter related to becoming a standalone public company.

As of the Separation date, we operate under a new standalone legal entity structure. In connection with the Separation, adjustments have been made to the income tax accounts. See Note 2B. The Separation, Adjustments Associated with the Separation, Senior Notes Offering, Initial Public Offering and Exchange Offer: Adjustments Associated with the Separation.

B. Tax Matters Agreement

In connection with the Separation, we entered into a tax matters agreement with Pfizer that governs the parties' respective rights, responsibilities and obligations with respect to tax liabilities and benefits, tax attributes, the preparation and filing of tax returns, the control of audits and other tax proceedings and other matters regarding taxes. For additional information, see below and Note 17B. Transactions and Agreements with Pfizer: Agreements with Pfizer.

In connection with this agreement and the Separation, the activity in our income tax accounts reflects Separation Adjustments, including significant adjustments to the deferred income tax asset and liability accounts and the tax liabilities associated with uncertain tax positions. For additional information, see below and Note 2B. The Separation, Adjustments Associated with the Separation, Senior Notes Offering, Initial Public Offering and Exchange Offer: Adjustments Associated with the Separation.

In general, under the agreement:

- Pfizer will be responsible for any U.S. federal, state, local or foreign income taxes and any U.S. state or local non-income taxes (and any related interest, penalties or audit adjustments and including those taxes attributable to our business) reportable on a consolidated, combined or unitary return that includes Pfizer or any of its subsidiaries (and us and/or any of our subsidiaries) for any periods or portions thereof ending on or prior to December 31, 2012. We will be responsible for the portion of any such taxes for periods or

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portions thereof beginning on or after January 1, 2013, as would be applicable to us if we filed the relevant tax returns on a standalone basis.

- We will be responsible for any U.S. federal, state, local or foreign income taxes and any U.S. state or local non-income taxes (and any related interest, penalties or audit adjustments) that are reportable on returns that include only us and/or any of our subsidiaries, for all tax periods whether before or after the completion of the Separation.
- Pfizer will be responsible for certain specified foreign taxes directly resulting from certain aspects of the Separation.

We will not generally be entitled to receive payment from Pfizer in respect of any of our tax attributes or tax benefits or any reduction of taxes of Pfizer. Neither party's obligations under the agreement will be limited in amount or subject to any cap. The agreement also assigns responsibilities for administrative matters, such as the filing of returns, payment of taxes due, retention of records and conduct of audits, examinations or similar proceedings. In addition, the agreement provides for cooperation and information sharing with respect to tax matters.

Pfizer will be primarily responsible for preparing and filing any tax return with respect to the Pfizer affiliated group for U.S. federal income tax purposes and with respect to any consolidated, combined, unitary or similar group for U.S. state or local or foreign income tax purposes or U.S. state or local non-income tax purposes that includes Pfizer or any of its subsidiaries, including those that also include us and/or any of our subsidiaries. We will generally be responsible for preparing and filing any tax returns that include only us and/or any of our subsidiaries.

The party responsible for preparing and filing a given tax return will generally have exclusive authority to control tax contests related to any such tax return.

C. Deferred Taxes

As of June 30, 2013, the total net deferred income tax liability of $165 million is included in Current deferred tax assets ($92 million), Noncurrent deferred tax assets ($54 million), Other current liabilities ($3 million) and Noncurrent deferred tax liabilities ($308 million).

As of December 31, 2012, the total net deferred income tax liability of $8 million is included in Current deferred tax assets ($101 million), Noncurrent deferred tax assets ($216 million), Other current liabilities ($2 million) and Noncurrent deferred tax liabilities ($323 million).

The significant increase in the total net deferred tax liability from December 31, 2012 to June 30, 2013 is primarily attributable to the Separation Adjustments, predominantly related to deferred tax assets associated with net operating loss/credit carry forwards and deferred tax liabilities associated with unremitted earnings that were retained by Pfizer. See Note 2B. The Separation, Adjustments Associated with the Separation, Senior Notes Offering, Initial Public Offering and Exchange Offer: Adjustments Associated with the Separation.

D. Tax Contingencies

As of June 30, 2013, the tax liabilities associated with uncertain tax positions of $35 million (exclusive of interest related to uncertain tax positions of $9 million) were included in Noncurrent deferred tax assets ($6 million) and Other taxes payable ($29 million).

As of December 31, 2012, the tax liabilities associated with uncertain tax positions of $144 million (exclusive of interest related to uncertain tax positions of $17 million) were included in Noncurrent deferred tax assets ($6 million) and Other taxes payable ($138 million).

The significant decrease in the tax liabilities associated with uncertain tax positions from December 31, 2012 to June 30, 2013 is primarily attributable to the Separation Adjustments predominantly related to liabilities retained by Pfizer. See Note 2B. The Separation, Adjustments Associated with the Separation, Senior Notes Offering, Initial Public Offering and Exchange Offer: Adjustments Associated with the Separation.

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.

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8. Accumulated Other Comprehensive Loss

Changes, net of tax, in accumulated other comprehensive loss follow:

(MILLIONS OF DOLLARS)	Currency Translation Adjustment Net Unrealized Gains/(Losses)	Benefit Plans Actuarial Losses	Accumulated Other Comprehensive Income/(Loss)
Balance, December 31, 2012	$(152)	$(5)	$(157)
Other comprehensive income/(loss), net of tax	(17)	(3)	(20)
Separation adjustments[(a)]	(7)	1	(6)
Balance, June 30, 2013	$(176)	$(7)	$(183)

(a) See Note 2B. The Separation, Adjustments Associated with the Separation, Senior Notes Offering, Initial Public Offering and Exchange Offer: Adjustments Associated with the Separation.

9. Financial Instruments

A. Credit Facility

In December 2012, we entered into a revolving credit agreement with a syndicate of banks providing for a five-year $1.0 billion senior unsecured revolving credit facility (the credit facility), which became effective in February 2013 upon the completion of the IPO and expires in December 2017. 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 4.35:1 for fiscal year 2013, 3.95:1 for fiscal year 2014, 3.50:1 for fiscal year 2015 and 3.00:1 thereafter. 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. Subject to certain conditions, we have the right to increase the credit facility to up to $1.5 billion. There are currently no borrowings outstanding.

B. Commercial Paper Program

In February 2013, we entered into a commercial paper program with a capacity of up to $1.0 billion. As of June 30, 2013, no commercial paper has been issued under this program.

C. Short-Term Borrowings

There were short-term borrowings of $12 million as of June 30, 2013. As of December 31, 2012 the current portion of allocated debt from Pfizer was $73 million. The weighted-average interest rate on short-term borrowings outstanding, including the current portion of allocated debt, was 4.6% and 3.7% as of June 30, 2013 and December 31, 2012, respectively.

D. Senior Notes Offering

On January 28, 2013, we issued $3.65 billion aggregate principal amount of our senior notes (the senior notes offering) in a private placement, with an original issue discount of $10 million. The senior notes are comprised of $400 million aggregate principal amount of our 1.150% senior notes due 2016, $750 million aggregate principal amount of our 1.875% Senior Notes due 2018, $1.35 billion aggregate principal amount of our 3.250% senior notes due 2023 and $1.15 billion aggregate principal amount of our 4.700% senior notes due 2043.

We sold $2.65 billion aggregate principal amount of our senior notes through the initial purchasers in the senior notes offering and Pfizer transferred $1.0 billion aggregate principal amount of our senior notes to certain of the initial purchasers, who sold such senior notes in the senior notes offering.

The 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 senior notes may be declared immediately due and payable.

Pursuant to the indenture, we are able to redeem the 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 2023 notes 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 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 purchase each of the senior notes at a price equal to 101% of the aggregate principal amount of the 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 follow:

(MILLIONS OF DOLLARS)	June 30, 2013	December 31, 2012
Allocated long-term debt	$—	$509
1.150% Senior Notes due 2016	400	—
1.875% Senior Notes due 2018	750	—
3.250% Senior Notes due 2023	1,350	—
4.700% Senior Notes due 2043	1,150	—
	3,650	509
Unamortized debt discount	(10)	—
Long-term debt / Allocated long-term debt	$3,640	$509

As of June 30, 2013, the fair value of our senior notes was $3,462 million 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's credit rating (Level 2 inputs). At December 31, 2012, the fair value of our allocated long-term debt was $732 million, and has been determined using a third-party matrix-pricing model that uses significant inputs derived from or corroborated by observable market data and Pfizer's credit rating (Level 2 inputs). See Note 4B. Significant Accounting Policies: Fair Value. The fair value of the allocated long-term debt as of December 31, 2012 does not purport to reflect the fair value that might have been determined if Zoetis had operated as a standalone public company for the periods presented or if we had used Zoetis's credit rating in the calculation.

The principal amount of long-term debt outstanding as of June 30, 2013 matures in the following years:

(MILLIONS OF DOLLARS)	2014	2015	2016	2017	2018	After 2018	Total
Maturities	$—	$—	$400	$—	$750	$2,500	$3,650

E. Derivative Financial Instruments

Foreign Exchange Risk

A significant portion of our revenues, earnings and net investment in foreign affiliates is exposed to changes in foreign exchange rates. Prior to the IPO, as a business unit of Pfizer and under Pfizer's global cash management system, our foreign exchange risk was managed through Pfizer. Following the Separation, we seek to manage our foreign exchange risk, in part, through operational means, including managing same-currency revenues in relation to same-currency costs and same-currency assets in relation to same-currency liabilities. Depending on market conditions, foreign exchange risk is also managed through the use of derivative financial instruments. These financial instruments serve to protect net income against the impact of the translation into U.S. dollars of certain foreign exchange-denominated transactions. As of June 30, 2013, the aggregate notional amount of foreign exchange derivative financial instruments offsetting foreign currency exposures was $1.3 billion. The derivative financial instruments primarily offset exposures in the euro, the Brazilian real and the Australian dollar. The vast majority of the foreign exchange derivative financial instruments mature within 60 days and all mature within 180 days.

All derivative contracts used to manage foreign currency risk are measured at fair value and are reported as assets or liabilities on the condensed consolidated balance sheet. The company has not designated the foreign currency forward-exchange contracts as hedging instruments. We recognize the gains and losses on forward-exchange contracts that are used to offset the same foreign currency assets or liabilities immediately into earnings along with the earnings impact of the items they generally offset. These contracts essentially take the opposite currency position of that reflected in the month-end balance sheet to counterbalance the effect of any currency movement.

Fair Value of Derivative Instruments

The location and fair values of derivative instruments not designated as hedging instruments at June 30, 2013 are as follows:

(MILLIONS OF DOLLARS)	Balance Sheet Location	Fair Value of Derivatives
Foreign currency forward-exchange contracts	Other current assets	$4

Foreign currency forward-exchange contracts	Other current liabilities	(1)
Total foreign currency forward-exchange contracts		$3

We use a market approach in valuing financial instruments on a recurring basis. Our derivative financial instruments measured at fair value on a recurring basis use Level 2 inputs in the calculation of fair value. See Note 4B. Significant Accounting Policies: Fair Value.

The net gains incurred on foreign currency forward-exchange contracts not designated as hedging instruments were $10 million and $19 million for the three and six months ended June 30, 2013, respectively, and are recorded in Other (income)/deductions—net.

10. Inventories

The components of inventory follow:

(MILLIONS OF DOLLARS)	June 30, 2013	December 31, 2012
Finished goods	$844	$799
Work-in-process	227	332
Raw materials and supplies	186	214
Inventories	$1,257	$1,345

11. Goodwill and Other Intangible Assets

A. Goodwill

The components of and changes in the carrying amount of goodwill follow:

(MILLIONS OF DOLLARS)	U.S.	EuAfME	CLAR	APAC	Total
Balance, December 31, 2012	$502	$157	$163	$163	$985
Other[a]	(2)	(1)	—	—	(3)
Balance, June 30, 2013	$500	$156	$163	$163	$982

[a] Primarily reflects adjustments for foreign currency translation.

The gross goodwill balance was $1,518 million as of June 30, 2013 and $1,521 million as of December 31, 2012. Accumulated goodwill impairment losses (generated entirely in fiscal 2002) were $536 million as of June 30, 2013 and December 31, 2012.

B. Other Intangible Assets

The components of identifiable intangible assets follow:

	As of June 30, 2013			As of December 31, 2012		
(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	$764	$(196)	$568	$762	$(173)	$589
Brands	216	(94)	122	216	(88)	128
Trademarks and trade names	53	(36)	17	54	(36)	18
Other	121	(115)	6	122	(115)	7
Total finite-lived intangible assets	1,154	(441)	713	1,154	(412)	742
Indefinite-lived intangible assets:						
Brands	39	—	39	39	—	39
Trademarks and trade names	67	—	67	67	—	67
In-process research and development	15	—	15	20	—	20
Total indefinite-lived intangible assets	121	—	121	126	—	126
Identifiable intangible assets	$1,275	$(441)	$834	$1,280	$(412)	$868

C. Amortization

Amortization expense related to 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 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 $16 million and $19 million for the three months ended June 30, 2013 and July 1, 2012, respectively, and $31 million and $35 million for the six months ended June 30, 2013 and July 1, 2012, respectively.

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12. Benefit Plans

Prior to the Separation from Pfizer, employees who met certain eligibility requirements participated in various defined benefit pension plans and postretirement plans administered and sponsored by Pfizer. Effective December 31, 2012, our employees ceased to participate in the Pfizer U.S. qualified defined benefit and U.S. retiree medical plans, and liabilities associated with our employees under these plans were retained by Pfizer. Pfizer is continuing to credit certain employees' service with Zoetis generally through December 31, 2017 (or termination of employment from Zoetis, if earlier) for certain early retirement benefits with respect to Pfizer's U.S. defined benefit pension and retiree medical plans. In connection with the employee matters agreement, Zoetis will be responsible for payment of three-fifths of the total cost of the service credit continuation (approximately $38 million) for these plans and Pfizer will fund the remaining two-fifths of the total cost (approximately $25 million). The $25 million capital contribution from Pfizer and corresponding contra-equity account (which will be reduced as the service credit continuation is incurred), is included in Employee benefit plan contribution from Pfizer Inc. in the Condensed Consolidated and Combined Statements of Equity at June 30, 2013. The amount of the service cost continuation payment to be paid by Zoetis to Pfizer was determined and fixed based on an actuarial assessment of the value of the grow-in benefits and will be paid in equal installments over a period of ten years. Pension and postretirement benefit expense associated with the extended service for certain employees in the U.S. plans, totaled approximately $2 million and $4 million for the three and six months ended June 30, 2013, respectively.

Prior to the Separation from Pfizer, employees in the U.S. who met certain eligibility requirements participated in a supplemental (non-qualified) savings plan sponsored by Pfizer. In the second quarter of 2013, Pfizer transferred the supplemental savings plan liability of approximately $14 million, cash of $9 million and a deferred tax asset of $5 million associated with employees transferred to us.

As part of the Separation, certain Separation Adjustments (see Note 2B. The Separation, Adjustments Associated with the Separation, Senior Notes Offering, Initial Public Offering and Exchange Offer: Adjustments Associated with the Separation) were made to transfer the assets and liabilities of certain international defined benefit pension plans including Austria, France, Germany, Greece, Italy, Mexico, South Africa, Taiwan and Thailand, to Zoetis in the first quarter of 2013, and we assumed the liabilities allocable to employees transferring to us. Prior to the Separation, these benefit plans were accounted for as multi-employer plans. Also, as part of the Separation Adjustments, a benefit plan in Germany was retained by Pfizer. The net obligation of the transferred plans totaled $25 million. At June 30, 2013, the projected benefit obligation and fair value of plan assets of the dedicated international pension plans in the Netherlands, Germany, India and Korea, as well as those plans transferred in the first quarter of 2013, were $64 million and $35 million, respectively. In the second quarter of 2013, a net liability of approximately $16 million was recognized for the pension obligations less the fair value of plan assets associated with additional defined benefit pension plans in certain international locations that will be transferred to us in 2014, in accordance with the applicable local separation agreements.

Pension expense associated with dedicated international pension plans was approximately $1 million and $2 million for the three and six months ended June 30, 2013, respectively. Pension expense associated with international benefit plans accounted for as multi-employer plans was approximately $2 million and $5 million for the three and six months ended June 30, 2013, respectively.

For the second quarter ended June 30, 2013, contributions to the dedicated international benefits plans and the international plans accounted for as multi-employer plans were $1 million and $3 million, respectively. For the six months ended June 30, 2013, contributions to the dedicated international benefits plans and the international plans accounted for as multi-employer plans were $1 million and $5 million, respectively. We expect to contribute approximately $8 million to these plans in 2013.

13. Share-Based Payments

A. Zoetis 2013 Equity and Incentive Plan

In January 2013, the Zoetis 2013 Equity and Incentive Plan (Equity Plan) became effective. The principal types of stock-based awards available under the Equity Plan may include, but are not limited to, the following:

- Stock Options. Stock options represent the right to purchase shares of our common stock within a specified period of time at a specified price. The exercise price for a stock option will be not less than 100% of the fair market value of the common stock on the date of grant. Stock options will have a contractual maximum term of ten years from the

date of grant. Stock options granted may include those intended to be “incentive stock options” within the meaning of Section 422 of the Code.

- Restricted Stock and Restricted Stock Units (RSUs). Restricted stock is a share of our common stock that is subject to a risk of forfeiture or other restrictions that will lapse subject to the recipient's continued employment, the attainment of performance goals, or both. Restricted stock units represent the right to receive shares of our common stock in the future (or cash determined by reference to the value of our common stock), subject to the recipient's continued employment, the attainment of performance goals, or both.
- Performance-Based Awards. Performance awards will require satisfaction of pre-established performance goals, consisting of one or more business criteria and a targeted performance level with respect to such criteria as a condition of awards vesting or being settled. Performance may be measured over a period of any length specified but not less than one year.
- Other Equity-Based or Cash-Based Awards. Our Compensation Committee is authorized to grant awards in the form of other equity-based awards or other cash-based awards, as deemed to be consistent with the purposes of the Equity Plan. The maximum value of the aggregate payment to be paid to any participant with respect to cash-based awards under the Equity Plan in respect of an annual performance period will be $10 million.

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In order to provide long-term incentives to, and facilitate the retention of, our employees, we granted stock options (or other awards as appropriate with respect to our employees in non-U.S. jurisdictions) and/or restricted stock units under the Equity Plan on January 31, 2013 and February 1, 2013, respectively, to 1,700 of our employees. These awards will vest on the applicable three year anniversary date.

B. Share-Based Compensation Expense

The components of share-based compensation expense follow:

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	June 30, 2013	July 1, 2012	June 30, 2013	July 1, 2012
Stock option expense	$2	$—	$4	$—
RSU expense	1	—	2	—
Pfizer stock benefit plans—direct	17	6	25	12
Share-based compensation expense—direct	20	6	31	12
Share-based compensation expense—indirect	—	3	—	5
Share-based compensation expense—total	$20	$9	$31	$17

C. Stock Options

Stock options are accounted for using a fair-value-based method at the date of grant in the consolidated statement of income. 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.

Eligible employees may receive Zoetis stock option grants. Zoetis stock options granted vest after three years of continuous service from the grant date and have a contractual term of 10 years.

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 noted in the following table, shown at their weighted-average values:

	Six Months Ended June 30, 2013	
Expected dividend yield[(a)]	1.0	%
Risk-free interest rate[(b)]	1.29	%
Expected stock price volatility[(c)]	28.2	%
Expected term[(d)] (years)	6.5	

(a) Determined using a constant dividend yield during the expected term of the Zoetis stock option.

(b) Determined using the interpolated yield on U.S. Treasury zero-coupon issues.

(c) Determined using implied volatility.

(d) Determined using expected exercise and post-vesting termination patterns.

The following table provides an analysis of stock option activity for the six months ended June 30, 2013:

	Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value[(a)] (MILLIONS)
Outstanding, December 31, 2012	—	$ —		
Granted	2,948,882	26.05		
Forfeited	(25,894)	26.00		
Outstanding, June 30, 2013	2,922,988	$ 26.05	9.6	$14
Exercisable, June 30, 2013	—	—	—	—

(a) Market price of underlying Zoetis common stock less exercise price.

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The following table summarizes data related to stock option activity:

(MILLIONS OF DOLLARS, EXCEPT PER STOCK OPTION AMOUNTS)	Six Months Ended/As of June 30, 2013
Weighted-average grant date fair value per stock option	$7.02
Total compensation cost related to nonvested stock options not yet recognized, pre-tax	$16
Weighted-average period over which stock option compensation is expected to be recognized (years)	2.0

D. Restricted Stock Units (RSUs)

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, the units vest after three years of continuous service from the grant date and the values determined using the fair-value-based method 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.

	Shares	Weighted-Average Grant Date Fair Value Per Share
Nonvested, December 31, 2012	—	$ —
Granted	808,243	26.13
Forfeited	(7,226)	26.00
Nonvested, June 30, 2013	801,017	$ 26.13

The follow table provides data related to RSU activity:

(MILLIONS OF DOLLARS)	Six Months Ended/As of June 30, 2013
Total compensation cost related to nonvested RSU awards not yet recognized, pre-tax	$19
Weighted-average period over which RSU cost is expected to be recognized (years)	2.6

E. Treatment of Outstanding Pfizer Equity Awards

Following the IPO, the equity awards previously granted to our employees by Pfizer continued to vest, and service with Zoetis counted as service with Pfizer for all purposes. On June 24, 2013, Pfizer completed the exchange offer whereby it disposed of all of the shares of common stock of Zoetis owned by Pfizer. Pfizer accelerated the vesting of, and in some cases the settlement of, on a pro-rated basis, outstanding Pfizer RSUs, Total Shareholder Return Units (TSRUs) and Performance Share Awards (PSAs), subject, in each case, to the requirements of Section 409A of the U.S. Internal Revenue Code, the terms of the 2004 Pfizer Stock Plan and the applicable award agreements and any outstanding deferral elections. In addition, unvested Pfizer stock options accelerated in full and, employees generally have the ability to exercise the stock options until the earlier of (i) June 23, 2016 (three years from Pfizer's completion of the exchange offer), (ii) termination of employee from Zoetis, or (iii) the expiration date of the stock option. Stock options held by employees who were retirement eligible as of June 24, 2013 will have the full term of the stock option to exercise.

The accelerated vesting of the outstanding Pfizer stock options, and the settlement, on a pro-rata basis, of other Pfizer equity awards, resulted in the recognition of additional expense for the three and six months ended June 30, 2013 of $9 million and is included in stock-based compensation. The unvested portion of Pfizer RSUs, TSRUs and PSAs were forfeited as of the completion of the exchange offer. Zoetis will make a cash payment of approximately $20 million in the third quarter of 2013, to certain non-executive Zoetis employees, based on the value of the employees' forfeited Pfizer RSUs, TSRUs and PSAs (as applicable). This amount was accrued as of June 30, 2013 and is included in the condensed consolidated statements of income as additional compensation expense for the three and six months ended June 30, 2013. Members of the Zoetis Executive Team will not receive a cash payment, but will instead be granted Zoetis RSUs in the third quarter of 2013, subject to vesting, equivalent in value to the value of the member's forfeited

Pfizer RSUs, TSRUs and PSAs.

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14. Earnings per Share

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

(MILLIONS OF DOLLARS AND SHARES, EXCEPT PER SHARE DATA)	Three Months Ended June 30, 2013	Three Months Ended July 1, 2012	Six Months Ended June 30, 2013	Six Months Ended July 1, 2012
Numerator				
Net income before allocation to noncontrolling interests	$128	$173	$268	$285
Less: net income attributable to noncontrolling interests	—	—	—	1
Net income attributable to Zoetis Inc.	$128	$173	$268	$284
Denominator				
Weighted-average common shares outstanding	500.000	500.000	500.000	500.000
Common stock equivalents: stock options and RSUs	0.217	—	0.164	—
Weighted-average common and potential dilutive shares outstanding	500.217	500.000	500.164	500.000
Earnings per share attributable to Zoetis Inc. stockholders—basic	$0.26	$0.35	$0.54	$0.57
Earnings per share attributable to Zoetis Inc. stockholders—diluted	$0.26	$0.35	$0.54	$0.57

15. Commitments and Contingencies

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

A. Legal Proceedings

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

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

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

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

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

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Roxarsone®(3-Nitro)

We are defendants in nine actions involving approximately 140 plaintiffs that allege that the distribution of the medicated feed additive Roxarsone allegedly caused various diseases in the plaintiffs, including cancers and neurological diseases. Other defendants, including various poultry companies, are also named in these lawsuits. Compensatory and punitive damages are sought in unspecified amounts.

In September 2006, the Circuit Court of Washington County returned a defense verdict in one of the lawsuits, Mary Green, et al. v. Alpharma, Inc. et al. In 2008, this verdict was appealed and affirmed by the Arkansas Supreme Court. Certain summary judgments favoring the poultry company co-defendants in Mary Green, et al. v. Alpharma, Inc. et al. were reversed by the Arkansas Supreme Court in 2008. These claims were retried in 2009 and that trial also resulted in a defense verdict, which was affirmed by the Arkansas Supreme Court in April 2011. In October 2012, we entered into an agreement to resolve these cases. The resolution is subject to the execution of full releases or dismissals with prejudice by all of the claimants or our waiver of these requirements. The trial schedule has been suspended pending the outcome of the proposed settlement.

In June 2011, we announced that we would suspend sales in the U.S. of Roxarsone (3-Nitro) in response to a request by the U.S. FDA and subsequently stopped sales in several international markets.

Following our decision to suspend sales of Roxarsone (3-Nitro) in June 2011, Zhejiang Rongyao Chemical Co., Ltd., the supplier of certain materials used in the production of Roxarsone (3-Nitro), filed a lawsuit in the U.S. District Court for the District of New Jersey alleging that we are liable for damages it suffered as a result of the decision to suspend sales.

PregSure®

We have received in total approximately 80 claims in Europe and New Zealand seeking damages related to calves claimed to have died of Bovine Neonatal Pancytopenia (BNP) on farms where PregSure BVD, a vaccine against Bovine Virus Diarrhea (BVD) was used. BNP is a rare syndrome that first emerged in cattle in Europe in 2006. Studies of BNP suggest a potential association between the administration of PregSure and the development of BNP, although no causal connection has been established. The cause of BNP is not known.

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

We have settled approximately 20 of these claims for amounts that are not material individually or in the aggregate. Investigations into possible causes of BNP continue and these settlements may not be representative of any future claims resolutions.

Advocin

On January 30, 2012, Bayer filed a complaint against Pfizer alleging infringement and inducement of infringement of Bayer patent US 5,756,506 covering, among other things, a process for treating bovine respiratory disease (BRD) by administering a single high dose of fluoroquinolone. The complaint was filed after Pfizer's product Advocin® was approved as a single dose treatment of BRD, in addition to its previous approval as a multi-dose treatment of BRD. Bayer seeks a permanent injunction, damages and a recovery of attorney's fees, and has demanded a jury trial. Discovery has now concluded. We have filed motions for summary judgment of non-infringement and invalidity of the Bayer patent, which are currently pending before the Court.

Ulianopolis, Brazil

In February 2012, the Municipality of Ulianopolis (State of Para, Brazil) filed a complaint against Fort Dodge Saúde Animal Ltda. (FDSAL) 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.

In early August 2013, new labor claims were filed against FDSAL as well as 57 other companies. These claims were filed by 30 employees of the local waste incineration facility that was used by FDSAL and the 57 other companies. The employees of the incineration facility allege health injuries in connection with their employment at the waste site. Based on legal precedent, it is possible that FDSAL may be considered a liable party. Due to the fact that we are in the early stages of discovery, the amount of a potential loss, if any, cannot be reasonably estimated. Counsel has advised that the likelihood of Zoetis being considered severally liable is remote.

Other Matters

The European Commission published a decision on alleged competition law infringements by several human health pharmaceutical companies on June 19, 2013. One of the involved legal entities is Zoetis Products LLC, formerly having the name Alpharma Inc. Zoetis Products LLC's involvement is solely related to its human health activities prior to Pfizer's acquisition of King/Alpharma. The fine imposed on Zoetis Products LLC amounts to Euro 11 million (approximately $14 million). 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. A liability of $14 million is included

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in Other current liabilities and a corresponding receivable from Pfizer of $14 million is included in Other current assets as of June 30, 2013. We are in the process of preparing an appeal of the decision which is due September 6, 2013.

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, 2013, recorded amounts for the estimated fair value of these indemnifications are not significant.

16. Segment and Other Revenue Information

A. Segment Information

The animal health medicines and vaccines industry is characterized by meaningful differences in customer needs across different regions. As a result of these differences, among other things, we manage our operations through four geographic regions. Each operating segment has responsibility for its commercial activities. Within each of these regional 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.

Operating Segments

- The United States (U.S.).
- Europe/Africa/Middle East (EuAfME)—Includes, among others, the United Kingdom, Germany, France, Italy, Spain, Northern Europe and Central Europe as well as Russia, Turkey and South Africa.
- Canada/Latin America (CLAR)—Includes Canada, Brazil, Mexico, Central America and Other South America.
- Asia/Pacific (APAC)—Includes Australia, Japan, New Zealand, South Korea, India, China/Hong Kong, Northeast Asia, Southeast Asia and South Asia.

Our chief operating decision maker uses the revenues and earnings of the four operating segments, among other factors, for performance evaluation and resource allocation.

Other Costs and Business Activities

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

- Research & development (R&D), which is generally responsible for research projects.
- Corporate, which is responsible for platform functions such as business technology, facilities, legal, finance, human resources, business development, public affairs and procurement, among others. These costs also include compensation costs and other miscellaneous operating expenses not charged to our operating segments, as well as interest income and expense.
- Certain transactions and events such as (i) purchase accounting adjustments, where we incur expenses associated with the amortization of fair value adjustments to inventory, intangible assets and property, plant and equipment; (ii) acquisition-related activities, where we incur costs for restructuring and integration; and (iii) certain significant items, which include non-acquisition-related restructuring charges, certain asset impairment charges and costs associated with cost reduction/productivity initiatives.

Segment Assets

We manage our assets on a total company basis, not by operating segment. Therefore, our chief operating decision maker does not regularly review any asset information by operating segment and, accordingly, we do not report asset information by operating segment. Total assets were approximately $6.3 billion at both June 30, 2013 and December 31, 2012.

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Selected Statement of Income Information

	Revenue[a]		Earnings[b]		Depreciation and Amortization[c]	
(MILLIONS OF DOLLARS)	June 30, 2013	July 1, 2012	June 30, 2013	July 1, 2012	June 30, 2013	July 1, 2012
Three months ended						
U.S.	$437	$421	$254	$227	$8	$8
EuAfME	278	283	91	88	6	6
CLAR	213	211	78	77	4	6
APAC	186	179	71	63	2	3
Total reportable segments	1,114	1,094	494	455	20	23
Other business activities[d]	—	—	(74)	(61)	6	5
Reconciling Items:						
Corporate[e]	—	—	(137)	(104)	13	11
Purchase accounting adjustments[f]	—	—	(13)	(13)	13	13
Acquisition-related costs[g]	—	—	(9)	(15)	—	2
Certain significant items[h]	—	—	(43)	14	—	—
Other unallocated[i]	—	—	(31)	(24)	(1)	—
	$1,114	$1,094	$187	$252	$51	$54
Six Months Ended						
U.S.	$891	$846	$488	$444	$22	$15
EuAfME	568	558	208	192	12	12
CLAR	384	384	130	131	9	12
APAC	361	353	146	134	6	7
Total reportable segments	2,204	2,141	972	901	49	46
Other business activities[d]	—	—	(148)	(126)	13	8
Reconciling Items:						
Corporate[e]	—	—	(253)	(233)	15	17
Purchase accounting adjustments[f]	—	—	(25)	(26)	25	26
Acquisition-related costs[g]	—	—	(15)	(29)	—	5
Certain significant items[h]	—	—	(85)	(17)	—	—
Other unallocated[i]	—	—	(67)	(47)	—	—
	$2,204	$2,141	$379	$423	$102	$102

(a) Revenue denominated in euros were $166 million and $334 million in the three and six months ended June 30, 2013, respectively and $158 million and $322 million in the three and six months ended July 1, 2012, respectively.

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

(c) 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.

(d) Other business activities reflect the research and development costs managed by our Research and Development organization.

(e) Corporate includes, among other things, administration expenses, interest expense, certain compensation and other costs not charged to our operating segments.

(f) Purchase accounting adjustments include certain charges related to the fair value adjustments to inventory, intangible assets and property, plant and equipment not charged to our operating segments.

(g) Acquisition-related costs can include costs associated with acquiring, integrating and restructuring acquired businesses, such as allocated transaction costs, integration costs, restructuring charges and additional depreciation

associated with asset restructuring. See Note 5. Restructuring Charges and Other Costs Associated with Acquisitions and Cost-Reduction/Productivity Initiatives, for additional information.

(h) Certain significant items are 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 items primarily include restructuring charges and implementation costs associated with our cost-reduction/productivity initiatives that are not associated with an acquisition, the impact of divestiture-related gains and losses and certain costs related to becoming a standalone public company. See Note 5. Restructuring Charges and Other Costs Associated with Acquisition and Cost-Reduction/Productivity Initiatives, for additional information.

In the second quarter of 2013, certain significant items primarily includes: (i) $27 million income related to a reversal of certain employee termination expenses; (ii) Zoetis stand-up costs of $77 million; and (iii) $6 million income on the government-mandated sale of certain product rights in Brazil that were acquired with the FDAH acquisition in 2009. Stand-up costs include certain nonrecurring costs related to becoming a standalone public company, such as new branding (including changes to the manufacturing process for required new packaging), the creation of standalone systems and

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infrastructure, site separation, accelerated vesting and associated cash payment related to certain Pfizer equity awards, and certain legal registration and patent assignment costs.

- In the second quarter of 2012, certain significant items includes: (i) $14 million income related to a favorable legal settlement for an intellectual property matter; (ii) $6 million income due to a change in estimate related to transitional manufacturing purchase agreements associated with divestitures; (iii) $12 million restructuring charges and implementation costs associated with our cost-reduction/productivity initiatives that are not associated with an acquisition; and (iv) $6 million income of other.
- In the six months ended June 30, 2013, certain significant items primarily includes: (i) additional depreciation associated with asset restructuring of $3 million, (ii) $27 million income related to a reversal of certain employee termination expenses; (iii) Zoetis stand-up costs of $111 million; and (iv) $6 million income on the government-mandated sale of certain product rights in Brazil that were acquired with the FDAH acquisition in 2009.
- In the six months ended July 1, 2012, certain significant items includes: (i) $14 million income related to a favorable legal settlement for an intellectual property matter; (ii) $5 million income due to a change in estimate related to transitional manufacturing purchase agreements associated with divestitures; and (iii) $36 million for restructuring charges and implementation costs associated with our cost-reduction/productivity initiatives that are not associated with an acquisition.

(i) Includes overhead expenses associated with our manufacturing operations.

B. Other Revenue Information

Revenue by Species

Significant species revenue are as follows:

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	June 30, 2013	July 1, 2012	June 30, 2013	July 1, 2012
Livestock:				
Cattle	$356	$371	$746	$771
Swine	152	142	310	285
Poultry	137	129	270	250
Other	25	23	50	50
	670	665	1,376	1,356
Companion Animal:				
Horses	45	50	87	95
Dogs and Cats	399	379	741	690
	444	429	828	785
Total revenue	$1,114	$1,094	$2,204	$2,141

Revenue by Major Product Category

Significant revenue by major product category are as follows:

	Three Months Ended		Six Months Ended	
(MILLIONS OF DOLLARS)	June 30, 2013	July 1, 2012	June 30, 2013	July 1, 2012
Anti-infectives	$280	$283	$587	$583
Vaccines	301	281	579	546
Parasiticides	208	216	377	377
Medicated feed additives	97	94	201	193
Other pharmaceuticals	193	187	381	364
Other non-pharmaceuticals	35	33	79	78
Total revenue	$1,114	$1,094	$2,204	$2,141

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17. Transactions and Agreements with Pfizer

Zoetis had related party transactions with Pfizer through the completion of the exchange offer on June 24, 2013. As of the completion of the exchange offer, Pfizer is no longer a related party. Activities while Pfizer was a related party, as well as ongoing agreements with Pfizer, are detailed below.

A. Pre-Separation Period

For the condensed combined statement of income for the three and six months ended ended July 1, 2012, the costs of goods manufactured in manufacturing plants that were shared with other Pfizer business units was approximately $105 million and $215 million, respectively.

In the pre-Separation period, Pfizer provided significant corporate, manufacturing and shared services functions and resources to us. Our condensed combined financial statements as of and for the three and six months ended ended July 1, 2012, respectively, reflect an allocation of these costs. For further information about the cost allocations for these services and resources, see Note 3A. Basis of Presentation: Basis of Presentation Prior to the Separation. Management believes that these allocations are a reasonable reflection of the services received. However, these allocations may not reflect the expenses that would have been incurred if we had operated as a standalone public company for the period presented.

Pfizer uses a centralized approach to cash management and financing its operations. In the pre-Separation period, cash deposits were remitted to Pfizer on a regular basis and were reflected in business unit equity and, similarly, Zoetis's cash disbursements were funded through Pfizer's cash accounts and were reflected within Business unit equity.

B. Agreements with Pfizer

In connection with the Separation and IPO, we and Pfizer entered into agreements that provide a framework for our ongoing relationship with Pfizer, certain of which are described below.

- Global separation agreement. This agreement governs the relationship between Pfizer and us following the IPO and includes provisions related to the allocation of assets and liabilities, indemnification, delayed transfers and further assurances, mutual releases, insurance and certain covenants.
- Transitional services agreement. This agreement grants us the right to continue to use certain of Pfizer's services and resources related to our corporate functions, such as business technology, facilities, finance, human resources, public affairs and procurement, in exchange for mutually agreed-upon fees based on Pfizer's costs of providing these services.
- Tax matters agreement. This agreement governs ours and Pfizer's respective rights, responsibilities and obligations with respect to tax liabilities and benefits, tax attributes, the preparation and filing of tax returns, the control of audits and other tax proceedings and other matters regarding taxes. Pursuant to this agreement, we have also agreed to certain covenants that contain restrictions intended to preserve the tax-free status of certain transactions, and we have agreed to indemnify Pfizer and its affiliates against any and all tax-related liabilities incurred by them relating to these transactions to the extent caused by an acquisition of our stock or assets or by any other action undertaken by us.
- Research and development collaboration and license agreement. This agreement permits certain of our employees to be able to review a Pfizer database to identify compounds that may be of interest to the animal health field. Pfizer has granted to us an option to enter into a license agreement subject to certain restrictions and requirements and we will make payments to Pfizer.
- Employee matters agreement. This agreement governs ours and Pfizer's respective rights, responsibilities and obligations with respect to the following matters: employees and former employees (and their respective dependents and beneficiaries) who are or were associated with Pfizer, us or the parties' respective subsidiaries or affiliates; the allocation of assets and liabilities generally relating to employees, employment or service-related matters and employee benefit plans; and other human resources, employment and employee benefits matters.
- Master manufacturing and supply agreements. These two agreements govern our manufacturing and supply arrangements with Pfizer. Under one of these agreements, Pfizer will manufacture and supply us with animal health products. Under this agreement, our manufacturing and supply chain leadership will have oversight responsibility over product quality and other key aspects of the manufacturing process with respect to the Pfizer-supplied products. Under the other agreement, we will manufacture and supply certain human health products to Pfizer.
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Environmental matters agreement. This agreement governs the performance of remedial actions for liabilities allocated to each party under the global separation agreement; addresses our substitution for Pfizer with respect to animal health assets and remedial actions allocated to us (including substitution related to, for example, permits, financial assurances and consent orders); allows our conditional use of Pfizer's consultants and contractors to assist in the conduct of remedial actions; and addresses the exchange of related information between the parties. The agreement also sets forth standards of conduct for remedial activities at the co-located facilities: Guarulhos, Brazil; Catania, Italy; Hsinchu, Taiwan; and Kalamazoo, Michigan in the U.S. In addition, the agreement sets forth site-specific terms to govern conduct at several of these co-located facilities.

- Screening services agreement. This agreement requires us to provide certain high throughput screening services to Pfizer's R&D organization for which Pfizer pays to us agreed-upon fees.
- Intellectual property license agreements. Under these agreements (i) Pfizer and certain of its affiliates licensed to us and certain of our affiliates the right to use certain intellectual property rights in the animal health field; (ii) we licensed to Pfizer and certain of its

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affiliates certain rights to intellectual property in all fields outside of the animal health field; and (iii) Pfizer granted us rights with respect to certain trademarks and copyrighted works.

Following the Separation, we own, have access to or have the right to use substantially all of the resources that were used, or held for use, exclusively in Pfizer's animal health business, including the following:

- Intellectual Property. As part of the Separation, Pfizer assigned to us ownership of certain animal health related patents, pending patent applications, and trademark applications and registrations. In addition, Pfizer licensed to us the right to use certain intellectual property rights in the animal health field. We licensed to Pfizer the right to use certain of our trademarks and substantially all of our other intellectual property rights in the human health field and all other fields outside of animal health. In addition, Pfizer granted us a transitional license to use certain of Pfizer's trademarks and we granted Pfizer a transitional license to use certain of our trademarks for a period of time following the completion of the IPO.
- Manufacturing Facilities. Our global manufacturing network consists of 13 “anchor” manufacturing sites and 16 “satellite” manufacturing sites. Ownership of, or the existing leasehold interest in, these facilities were conveyed to us by Pfizer as part of the Separation. Among these 29 manufacturing sites is our facility in Guarulhos, Brazil, which we leased back to Pfizer. Certain of our products are currently manufactured at 14 manufacturing sites that were retained by Pfizer. The products manufactured by Pfizer at these sites and at our Guarulhos, Brazil facility continues to be supplied to us under the terms of a manufacturing and supply agreement we entered into with Pfizer.
- R&D Facilities. We have R&D operations co-located with certain of our manufacturing sites in Australia, Belgium, Brazil, Canada, China, Spain and the United States to facilitate the efficient transfer of production processes from our laboratories to manufacturing sites. In addition, we maintain R&D operations at non-manufacturing locations in Belgium, Brazil, India and the United States. As part of the Separation, Pfizer conveyed to us its interest in each of these R&D facilities, with the exception of our Mumbai, India facility, which we expect Pfizer to transfer to us for agreed upon cash consideration after the completion of the Separation, and, in the interim, we are leasing this facility from Pfizer.
- Employees. In general, as part of the Separation, employees of Pfizer who were substantially dedicated to the animal health business became our employees. However, labor and employment laws or other business considerations in some jurisdictions delayed Pfizer from transferring to us employees who are substantially dedicated to the animal health business. In those instances, to the extent permissible under applicable law, we and Pfizer entered into mutually-acceptable arrangements to provide for continued operation of the business until such time as the employees in those jurisdictions can be transferred to us.

The amounts charged under each of the agreements with Pfizer for the three and six months ended June 30, 2013 are as follows:

(MILLIONS OF DOLLARS)	Three Months Ended June 30, 2013	Six months Ended June 30, 2013
Transitional services agreement	$31	$58
Master manufacturing and supply agreements	65	122
Employee matters agreement	51	99

In certain jurisdictions, while the Zoetis entities obtain appropriate registration and licensing, Pfizer entities purchase product from Zoetis entities and resell such product to the local Zoetis entity at cost. This activity is reflected in Accounts receivable for the product Pfizer purchases from Zoetis entities and in Accounts payable for the product purchased from such Pfizer entities by our local Zoetis entity.

At June 30, 2013, $212 million was included in Accounts receivable as receivable from Pfizer and $297 million was included in Accounts payable as payable to Pfizer.

We remained part of Pfizer's consolidated U.S. tax returns until we fully separated on June 24, 2013, and therefore reflected 2013 U.S. income taxes payable of $31 million as a payable to Pfizer in Other current liabilities.

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Review Report of Independent Registered Public Accounting Firm

The Board of Directors
Zoetis Inc.:

We have reviewed the accompanying condensed consolidated balance sheet of Zoetis Inc. and subsidiaries (the Company) as of June 30, 2013, the related condensed consolidated statements of income and comprehensive income for the three-month and six-month periods ended June 30, 2013, the related condensed consolidated statements of equity and cash flows for the six-month period ended June 30, 2013, the related condensed combined statements of income and comprehensive income for the three-month and six-month periods ended July 1, 2012, and the related condensed combined statements of equity and cash flows for the six-month period ended July 1, 2012. These condensed consolidated and condensed combined financial statements are the responsibility of the Company's management.

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

Based on our reviews, we are not aware of any material modifications that should be made to the condensed consolidated financial statements as of June 30, 2013 and for the three-month and six-month periods ended June 30, 2013 and to the condensed combined financial statements for the three-month and six-month periods ended July 1, 2012 referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the combined balance sheet of Zoetis Inc. (the animal health business unit of Pfizer Inc.) as of December 31, 2012, and the related combined statements of income, comprehensive income, equity, and cash flows for the year then ended (not presented herein); and in our report dated March 28, 2013, we expressed an unqualified opinion on those combined financial statements. In our opinion, the information set forth in the accompanying condensed combined balance sheet as of December 31, 2012, is fairly stated, in all material respects, in relation to the combined balance sheet from which it has been derived.

/s/ KPMG LLP
New York, New York
August 14, 2013

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)

Introduction

Our MD&A is provided in addition to the accompanying condensed consolidated and combined financial statements and notes to assist readers in understanding the results of operations, comprehensive income, financial condition and cash flows of Zoetis Inc. (Zoetis). This MD&A is organized as follows:

Section	Description	Page
Overview of our business	A general description of our business and the industry in which we operate. For more information regarding our business and the animal health industry, see Item 1. Business of our 2012 Annual Report on Form 10-K.	27
Our operating environment	Information regarding the animal health industry and factors that affect our company.	28
Comparability of historical results and our relationship with Pfizer	Information about the limitations of the predictive value of the condensed consolidated and combined financial statements.	30
Analysis of the condensed consolidated and combined statements of income	Consists of the following for all periods presented: • Revenues: An analysis of our revenues in total.	32
	• Costs and expenses: A discussion about the drivers of our costs and expenses.	32
	• Operating segment results: A discussion of our revenues by operating segment and species and items impacting our earnings before income tax.	37
Adjusted net income	A discussion of adjusted net income, an alternative view of performance used by management. Adjusted net income is a non-GAAP financial measure.	42
Our financial guidance for 2013	A discussion of our 2013 financial guidance.	46
Analysis of the condensed consolidated and combined statements of comprehensive income	An analysis of the components of comprehensive income for all periods presented.	46
Analysis of the condensed consolidated and combined balance sheets	A discussion of changes in certain balance sheet accounts for all balance sheets presented.	47
Analysis of the condensed consolidated and combined statements of cash flows	An analysis of the drivers of our operating, investing and financing cash flows for all periods presented.	47
Analysis of financial condition, liquidity and capital resources	An analysis of our ability to meet our short-term and long-term financing needs.	48
New accounting standards	Accounting standards that we have recently adopted, as well as those that recently have been issued, but not yet adopted.	50
Forward-looking statements and factors that may affect future results	A description of the risks and uncertainties that could cause actual results to differ materially from those discussed in forward-looking statements set forth in this MD&A relating to our financial and operating performance, business plans and prospects, strategic review, capital allocation and business-development plans. Such forward-looking statements are based on management's current expectations about future events, which are inherently susceptible to uncertainty and changes in circumstances.	51

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, as a business unit of Pfizer Inc. (Pfizer) and now as a standalone public company, we have been committed to enhancing the health of animals and bringing solutions to our customers who raise and care for them.

The animal health medicines and vaccines industry is characterized by meaningful differences in customer needs across different regions. As a result of these differences, among other things, we manage our operations through four geographic operating segments. 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. Our four operating segments are the United States (U.S.), Europe/Africa/Middle East (EuAfME), Canada/Latin America (CLAR) and Asia/Pacific (APAC). See Notes to Condensed Consolidated and Combined Financial Statements—Note 16. Segment and Other Revenue Information.

We directly market our products to livestock producers and veterinarians located in approximately 70 countries across North America, Europe, Africa, Asia, Australia and Latin 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 India, we believe we are the largest animal health medicines and vaccines business as measured by revenues 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.

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We believe our investments in the industry's largest sales organization, including our extensive network of technical and veterinary operations specialists, our high-quality manufacturing and reliability of supply, and our long track record of developing products that meet customer needs, has led to enduring and valued relationships with our customers. Our 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.

A summary of our 2013 performance compared to the comparable 2012 period follows:

	Three Months Ended			Six Months Ended		
(MILLIONS OF DOLLARS)	June 30, 2013	July 1, 2012	% Change	June 30, 2013	July 1, 2012	% Change
Revenues	$1,114	$1,094	2	$2,204	$2,141	3
Net income attributable to Zoetis	128	173	(26)	268	284	(6)
Adjusted net income[(a)]	178	176	1	357	328	9

(a) Adjusted net income is a non-GAAP financial measure, see the "Adjusted net income" section of this MD&A for more information.

Our ownership

On February 6, 2013, an initial public offering (IPO) of our Class A common stock was completed, which represented approximately 19.8% of our total outstanding shares. Following the IPO, Pfizer owned 100% of our outstanding Class B common stock and no shares of our Class A common stock, giving Pfizer 80.2% of the economic interest and the combined voting power in shares of our outstanding common stock other than with respect to the election of directors and 97.6% of the combined voting power of our outstanding common stock with respect to the election of directors. On February 1, 2013, our Class A common stock began trading on the New York Stock Exchange under the symbol "ZTS." Prior to and in connection with the IPO, we completed a $3.65 billion senior notes offering and Pfizer transferred to us substantially all of the assets and liabilities of their animal health business. We refer to the transactions to separate our business from Pfizer as described here and elsewhere in this quarterly report as the Separation.

On May 22, 2013, Pfizer announced an exchange offer whereby Pfizer shareholders could exchange a portion of Pfizer common stock for Zoetis common stock. The exchange offer was completed on June 24, 2013, resulting in the full separation of Zoetis and the disposal of Pfizer's entire ownership and voting interest. Following the exchange offer, there are no shares of our Class B common stock outstanding.

Our operating environment

Industry

The animal health industry, which focuses on both livestock and companion animals, is a growing industry that impacts billions of people worldwide. The primary livestock species for the production of animal protein are cattle (both beef and dairy), swine, poultry, sheep and fish. Livestock health and production are essential to meeting the growing demand for animal protein of a global population. Factors influencing growth in demand for livestock medicines and vaccines include:

- human population growth and increasing standards of living, particularly in many emerging markets;
- increasing demand for improved nutrition, particularly animal protein;
- natural resource constraints, such as scarcity of arable land, fresh water and increased competition for cultivated land, resulting in fewer resources that will be available to meet this increased demand for animal protein; and
- increased focus on food safety.

The primary companion animal species are dogs, cats and horses. Health professionals indicate that companion animals improve the physical and emotional well-being of pet owners. Factors influencing growth in demand for companion animal medicines and vaccines include:

- economic development and related increases in disposable income, particularly in many emerging markets;
- increasing pet ownership; and
- companion animals living longer, increasing medical treatment of companion animals and advances in companion animal medicines and vaccines.

Product development initiatives

Our future success depends on both our existing product portfolio and our pipeline of new products, including new products that we may develop through joint ventures and products that we are able to obtain through license or acquisition. We believe we are an industry leader in animal health R&D, with a track record of generating new products and brand lifecycle developments. The majority of our R&D programs focus on brand lifecycle development, which is defined as R&D programs that leverage existing animal health products by adding new species or claims, achieving approvals in new markets or creating new combinations and reformulations.

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Perceptions of product quality, safety and reliability

We believe that animal health medicines and vaccines customers value high-quality manufacturing and reliability of supply. The importance of quality and safety concerns to pet owners, veterinarians and livestock producers also contributes to animal health brand loyalty, which we believe often continues after the loss of patent-based and regulatory exclusivity. We depend on positive perceptions of the safety and quality of our products, and animal health products generally, by our customers, veterinarians and end-users.

The issue of the potential transfer of increased antibacterial resistance in bacteria from food-producing animals to human pathogens, and the causality of that transfer, are the subject of global scientific and regulatory discussion. In some countries, this issue has led to government restrictions and bans on the use of specific antibacterials in some food-producing animals, regardless of the route of administration (topical, oral, intramuscular/subcutaneous injections, or intravenous). These restrictions are more prevalent in countries where animal protein is plentiful and governments are willing to take restrictive actions even when there is scientific uncertainty. Historically, antibacterials for livestock have represented a significant portion of our revenues. We cannot predict whether antibacterial resistance concerns will result in additional restrictions or bans, expanded regulations or public pressure to discontinue or reduce use of antibacterials in food-producing animals.

The overall economic environment

In addition to industry-specific factors, we, like other businesses, continue to face the effects of the current challenging economic environment. Growth in both the livestock and companion animal sectors is driven by overall economic development and related growth, particularly in many emerging markets. Certain of our customers and suppliers have been affected directly by the economic downturn, which decreases the demand for our products and hinders our ability to collect amounts due from customers.

The cost of medicines and vaccines to our livestock producer customers is small relative to other production costs, including feed, and the use of these products are intended to improve livestock producers' economic outcomes. As a result, historically demand for our products has often been more stable than demand for other production inputs. Similarly, industry sources have reported that pet owners indicated a preference for reducing spending on other aspects of their lifestyle, including entertainment, clothing and household goods, before reducing spending on pet care. While these factors have mitigated the impacts of the challenging economic environment, the impact of difficult macroeconomic conditions increases over time.

Competition

The animal health industry is competitive. Although our business is the largest by revenues in the animal health medicines and vaccines industry, we face competition in the regions and sectors in which we compete. Principal methods of competition vary depending on the particular region, species, product category or individual product. Some of these methods include new product development, quality, price, service and promotion to veterinary professionals, pet owners and livestock producers. Our competitors include the animal health businesses of large pharmaceutical companies and specialty animal health businesses. In addition to competition from established market participants, there could be new entrants to the animal health medicines and vaccines industry in the future. In certain markets, we also compete with companies that produce generic products, but the level of competition from generic products varies from market to market. For example, the level of generic competition is higher in Europe and certain emerging markets than in the U.S.

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.

Weather conditions and the availability of natural resources

The animal health industry and demand for many of our animal health products in a particular region are affected by weather conditions, as usage of our products follows varying weather patterns and weather-related pressures from pests, such as ticks. As a result, we may experience regional and seasonal fluctuations in our results of operations. In addition, livestock producers depend on the availability of natural resources, including large supplies of fresh water. Their animals' health and their ability to operate could be adversely affected if they experience a shortage of fresh

water due to human population growth or floods, droughts or other weather conditions. In the event of adverse weather conditions or a shortage of fresh water, livestock producers may purchase less of our products.
For example, drought conditions could negatively impact, among other things, the supply of corn and the availability of grazing pastures. A decrease in harvested corn results in higher corn prices, which could negatively impact the profitability of livestock producers of cattle, pork and poultry. Higher corn prices and reduced availability of grazing pastures contributes to reductions in herd or flock sizes that in turn results in less spending on animal health products. As such, a prolonged drought could have a material adverse impact on our operating results and financial condition. Factors influencing the magnitude and timing of effects of a drought on our performance include, but may not be limited to, weather patterns and herd management decisions. The drought which has impacted parts of the U.S. over the past two years, is considered the worst in many years and affected our performance in the U.S. market in 2012 and in the first six months of 2013, and may continue to affect our performance, especially in cattle products, during the remainder of 2013.

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Disease outbreaks

Sales of our livestock products could be adversely affected by the outbreak of disease carried by animals. Outbreaks of disease may reduce regional or global sales of particular animal-derived food products or result in reduced exports of such products, either due to heightened export restrictions or import prohibitions, which may reduce demand for our products. Also, the outbreak of any highly contagious disease near our main production sites could require us to immediately halt production of our products at such sites or force us to incur substantial expenses in procuring raw materials or products elsewhere. Alternatively, sales of products that treat specific disease outbreaks may increase. For example, in 2012, we successfully launched a vaccine for horses against the deadly Hendra virus in Australia.

In 2013, there have been several reported cases of the H7N9 avian influenza virus in China. In late March 2013, the Chinese government reported the first case of the H7N9 avian influenza virus. Since that time, over 100 cases have been detected. We are closely monitoring the developments as this situation unfolds and currently believe the impact on our 2013 global revenue will not be significant. While China continues to represent a growth opportunity for us, sales in this country represented less than 2% of our total revenue in 2012 and the majority were generated by our swine business.

In addition, in the second quarter of 2013 some producers in the U.S. are experiencing an outbreak of the Porcine Epidemic Diarrhea Virus or PEDV. It is important to note that the virus, which affects piglets, does not create a food safety issue. We are committed to supporting U.S. pork producers in understanding and controlling PEDV, and we are partnering with the stakeholders, including various academic institutions such as the University of Minnesota. The outbreak to date has been limited in nature and we currently believe the impact on our 2013 revenue will not be significant.

Foreign exchange rates

Significant portions of our revenues and costs are exposed to changes in foreign exchange rates. Our products are sold in more than 120 countries and, as a result, our revenues are influenced by changes in foreign exchange rates. For the six months ended June 30, 2013, approximately 54% of our revenues were denominated in foreign currencies. Prior to the IPO, as a business unit of Pfizer and under Pfizer's global cash management system, our foreign exchange risk was managed through Pfizer. Following the Separation, we seek to manage our foreign exchange risk, in part, through operational means, including managing same-currency revenues 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 euro, the Brazilian real, the Australian dollar and other currencies, changes in those currencies relative to the U.S. dollar will impact our revenues 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, 2013, approximately 46% of our total revenues were in U.S. dollars, and our year-over-year revenue growth was unfavorably impacted by 1% from changes in foreign currency values relative to the U.S. dollar.

On February 13, 2013, the Venezuelan government devalued its currency from a rate of 4.3 to 6.3 Venezuelan bolivars per U.S. dollar. We incurred a foreign currency loss of $9 million immediately on the devaluation as a result of remeasuring the local assets and liabilities, which is included in Other (income)/deductions—net for the six months ended June 30, 2013. We will experience ongoing adverse impacts to earnings as our revenues, costs and expenses will be translated into U.S. dollars at lower rates. These impacts are not expected to be significant to our financial condition or results of operations.

Comparability of historical results and our relationship with Pfizer

During the periods covered by the combined financial statements prior to our IPO, we operated solely as a business unit of Pfizer. The combined financial statements have been derived from the consolidated financial statements and accounting records of Pfizer and include allocations for direct costs and indirect costs attributable to the operations of the animal health business of Pfizer. The combined financial statements do not purport to reflect what the results of operations, comprehensive income/(loss), financial position, equity or cash flows would have been had we operated as a standalone public company during these periods. In addition, the historical combined financial statements may not be reflective of what our results of operations, comprehensive income/(loss), financial position, equity or cash flows might be in the future as a standalone public company.

For a detailed description of the basis of presentation and an understanding of the limitations of the predictive value of the historical combined financial statements, see Notes to Condensed Consolidated and Combined Financial Statements—Note 3. Basis of Presentation.

The historical balance sheets may not be comparable to the balance sheet of the standalone company, which reflects the transfer by Pfizer of substantially all of its animal health business to us. Non-comparable elements include, for example, the allocation of Pfizer debt which was not transferred, cash and cash equivalents which were transferred at a predetermined amount, and other assets and liabilities which were not transferred due to legal restrictions and other decisions taken by Pfizer.

Our historical expenses are not necessarily indicative of the expenses we may incur in the future as a standalone public company. With respect to support functions, for example, our historical combined financial statements include expense allocations for certain support functions that are provided on a centralized basis within Pfizer, such as expenses for business technology, facilities, legal, finance, human resources, and, to a lesser extent, business development, public affairs and procurement, among others. As part of the Separation, pursuant to agreements with Pfizer, Pfizer provides us with some of the services related to these functions on a transitional basis in exchange for agreed-upon fees, and we are incurring other costs to replace the services and resources that will not be provided by Pfizer. As a standalone public company, our total costs related to such support functions may differ from the costs that were historically allocated to us from Pfizer.

We also expect to incur certain nonrecurring costs related largely to becoming a standalone public company, including new branding (which includes changes to the manufacturing process for required new packaging), the creation of a standalone infrastructure, the implementation of a

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new ERP system, the accelerated vesting of Pfizer equity awards, site separation and certain legal registration and patent assignment costs. In the second quarter of 2013, these costs were offset by the reversal of certain employee termination expenses. In addition, we will also incur certain costs related to the completion of FDAH integration activities. We expect all of the aforementioned nonrecurring costs to range between approximately $200 million to $240 million in 2013 and an additional $100 million to $140 million in 2014. These estimates exclude the impact of any depreciation or amortization of capitalized separation expenditures.

Following the IPO, the equity awards previously granted to our employees by Pfizer continued to vest, and service with Zoetis counted as service with Pfizer for all purposes. On June 24, 2013, Pfizer completed the exchange offer whereby it disposed of all of the shares of common stock of Zoetis owned by Pfizer. Pfizer accelerated the vesting of, and in some cases the settlement of, on a pro-rated basis, outstanding Pfizer RSUs, TSRUs and PSAs, subject, in each case, to the requirements of Section 409A of the U.S. Internal Revenue Code, the terms of the 2004 Stock Plan and the applicable award agreements and any outstanding deferral elections. In addition, unvested stock options granted by Pfizer accelerated in full and, generally, employees have the ability to exercise the stock options until the earlier of (i) June 23, 2016 (three years from when Pfizer completed the exchange offer), (ii) termination of employee from Zoetis, or (iii) the expiration date of the stock option. Stock options held by employees who were retirement eligible as of June 24, 2013 will have the full term of the stock option to exercise.

The accelerated vesting of the outstanding Pfizer stock options, and the settlement, on a pro-rata basis, of other Pfizer equity awards, resulted in the recognition of additional expense for the three and six months ended June 30, 2013 of $9 million and is included in stock-based compensation. The unvested portion of Pfizer RSUs, TSRUs and PSAs were forfeited as of the completion of the exchange offer. Zoetis will make a cash payment of approximately $20 million in the third quarter of 2013, to certain non-executive Zoetis employees, based on the value of the employees' forfeited Pfizer RSUs, TSRUs and PSAs (as applicable). This amount was accrued as of June 30, 2013 and is included in the condensed consolidated statements of income as additional compensation expense for the three and six months ended June 30, 2013. Members of the Zoetis Executive Team will not receive a cash payment, but will instead be granted Zoetis RSUs, subject to vesting, equivalent in value to the value of the member's forfeited Pfizer RSUs, TSRUs and PSAs.

Public company expenses

As a result of the IPO, we became subject to the reporting requirements of the Exchange Act and the Sarbanes-Oxley Act. We have established additional procedures and practices as a standalone public company. As a result, we are incurring additional costs, including internal audit, investor relations, stock administration and regulatory compliance costs.

Recent significant acquisitions and government-mandated divestitures

The assets, liabilities, operating results and cash flows of acquired businesses are included in our results commencing from their respective acquisition dates.

Delays in establishing new operating subsidiaries

Due to local regulatory and operational requirements in certain non-U.S. jurisdictions, the transfer to us of certain assets and liabilities of Pfizer's animal health business had not yet legally occurred as of the IPO Date. These assets and liabilities were not material to our consolidated financial statements, individually or in the aggregate. As of June 30, 2013, all expected subsidiaries have been established.

Agreements with Pfizer

On February 6, 2013, we entered into a transitional services agreement with Pfizer whereby Pfizer agreed to provide us with various corporate support services. This agreement has a service commencement date of January 1, 2013 in the United States and December 1, 2012 for our international locations. In addition, we also entered into a master manufacturing and supply agreement with Pfizer on October 1, 2012, whereby we and Pfizer agreed to manufacture and supply products to each other commencing January 1, 2013. See Notes to Condensed Consolidated and Combined Financial Statements— Note 17B. Transactions and Agreements with Pfizer: Agreements with Pfizer for more information related to these and other agreements, including the related costs.

Analysis of the condensed consolidated and combined statements of income

The following discussion and analysis of our statements of income should be read along with our consolidated and combined 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, 2013	July 1, 2012	% Change	June 30, 2013	July 1, 2012	% Change
Revenues	$1,114	$1,094	2	$2,204	$2,141	3
Costs and expenses:						
Cost of sales[(a)]	416	378	10	818	771	6
% of revenues	37 %	35 %		37 %	36 %	
Selling, general and administrative expenses[(a)]	399	344	16	756	682	11
% of revenues	36 %	31 %		34 %	32 %	
Research and development expenses[(a)]	95	92	3	185	194	(5)
% of revenues	9 %	8 %		8 %	9 %	
Amortization of intangible assets[(a)]	15	16	(6)	30	32	(6)
Restructuring charges and certain acquisition-related costs	(20)	24	*	(13)	49	*
Interest expense	32	8	*	54	16	*
Other (income)/deductions—net	(10)	(20)	(50)	(5)	(26)	(81)
Income before provision for taxes on income	187	252	(26)	379	423	(10)
% of revenues	17 %	23 %		17 %	20 %	
Provision for taxes on income	59	79	(25)	111	138	(20)
Effective tax rate	31.6 %	31.3 %		29.3 %	32.6 %	
Net income before allocation to noncontrolling interests	128	173	(26)	268	285	(6)
Less: Net income attributable to noncontrolling interests	—	—	—	—	1	(100)
Net income attributable to Zoetis	$128	$173	(26)	$268	$284	(6)
% of revenues	11 %	16 %		12 %	13 %	

* 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 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, 2013 vs. three months ended July 1, 2012

Total revenues increased by $20 million, or 2%, in the second quarter of 2013 compared to the second quarter of 2012, reflecting higher operational revenue of $39 million or 4%, partially offset by the unfavorable impact of foreign exchange, which decreased revenue by approximately $19 million, or 2%. We experienced operational growth led by the increased revenue in the U.S. segment.

Six months ended June 30, 2013 vs. six months ended July 1, 2012

Total revenue increased by $63 million, or 3%, in the first six months of 2013 compared to the same period in 2012, reflecting higher operational revenue of $90 million or 4%, partially offset by the unfavorable impact of foreign exchange, which decreased revenue by approximately $27 million, or 1%. We experienced operational growth across each of our regional segments, led by the increased revenue in the U.S. segment.

Costs and Expenses

Cost of sales

	Three Months Ended			Six Months Ended		
(MILLIONS OF DOLLARS)	June 30, 2013	July 1, 2012	% Change	June 30, 2013	July 1, 2012	% Change
Cost of sales[a]	$416	$378	10 %	$818	$771	6 %
% of revenue	37.3 %	34.6 %		37.1 %	36.0 %	

Certain amounts and percentages may reflect rounding adjustments.

(a) Allocation of corporate enabling functions were $3 million in the first quarter of 2013. There were no allocated expenses in the second quarter of 2013. Allocation of corporate enabling functions were $0 million and $1 million in the three and six months ended July 1, 2012, respectively.

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Three months ended June 30, 2013 vs. three months ended July 1, 2012

Cost of sales increased by $38 million, or 10%, in the second quarter of 2013 compared to the second quarter of 2012, primarily as a result of:

- revenue growth and product mix;
- additional one-time costs of $13 million related to becoming a standalone public company, including expense of $2 million due to the accelerated vesting of certain Pfizer equity awards and associated cash payments, as a result of the Separation; and
- higher costs associated with certain manufacturing agreements related to government-mandated divestitures from prior acquisitions,

partially offset by:

- operational efficiencies and related savings.

Six months ended June 30, 2013 vs. six months ended July 1, 2012

Cost of sales increased by $47 million, or 6%, in the first six months of 2013 compared to the first six months of 2012, primarily as a result of:

- revenue growth;
- additional one-time costs of $15 million related to becoming a standalone public company, including expense of $2 million due to the accelerated vesting of certain Pfizer equity awards and associated cash payments, as a result of the Separation; and
- higher costs associated with certain manufacturing agreements related to government-mandated divestitures from prior acquisitions,

partially offset by:

- operational efficiencies and related savings; and
- lower employee benefit costs due to the termination of the defined benefit pension plan for U.S. employees.

Selling, general and administrative expenses

	Three Months Ended			Six Months Ended		
(MILLIONS OF DOLLARS)	June 30, 2013	July 1, 2012	% Change	June 30, 2013	July 1, 2012	% Change
Selling, general and administrative expenses[(a)]	$399	$344	16 %	$756	$682	11 %
% of revenue	36 %	31 %		34 %	32 %	

Certain amounts and percentages may reflect rounding adjustments.

(a) Allocation of corporate enabling functions were $24 million in the first quarter of 2013. There were no allocated expenses in the second quarter of 2013. Allocation of corporate enabling functions were $60 million and $123 million in the three and six months ended July 1, 2012, respectively.

Three months ended June 30, 2013 vs. three months ended July 1, 2012

Selling, general & administrative (SG&A) expenses increased by $55 million, or 16%, in the second quarter of 2013 compared to the second quarter of 2012, primarily as a result of:

- additional one-time costs of $60 million related to becoming a standalone public company, including expense of $25 million due to the accelerated vesting of certain Pfizer equity awards and associated cash payments, as a result of the Separation; and
- the cost of initiatives to increase sales in certain emerging markets,

partially offset by:

- lower employee benefit costs due to the termination of the defined benefit pension plan for U.S. employees; and
- favorable foreign exchange.

Six months ended June 30, 2013 vs. six months ended July 1, 2012

SG&A expenses increased by $74 million, or 11%, in the first six months of 2013 compared to the first six months of 2012, primarily as a result of:

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additional one-time costs of $92 million related to becoming a standalone public company, including expense of $25 million due to the accelerated vesting of certain Pfizer equity awards and associated cash payments, as a result of the Separation; and

- the cost of initiatives to increase sales in certain emerging markets,

partially offset by:

- lower employee benefit costs due to the termination of the defined benefit pension plan for U.S. employees; and
- favorable foreign exchange.

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Research and development expenses

(MILLIONS OF DOLLARS)	Three Months Ended June 30, 2013	July 1, 2012	% Change	Six Months Ended June 30, 2013	July 1, 2012	% Change
Research and development expenses[(a)]	$95	$92	3 %	$185	$194	(5)%
% of revenue	9 %	8 %		8 %	9 %	

Certain amounts and percentages may reflect rounding adjustments.

(a) Allocation of corporate enabling functions were $13 million and $28 million in the three and six months ended July 1, 2012, respectively.

Three months ended June 30, 2013 vs. three months ended July 1, 2012

R&D expenses increased by $3 million, or 3%, in the second quarter of 2013 compared to the second quarter of 2012, primarily as a result of:

- additional one-time costs of $4 million due to the accelerated vesting of certain Pfizer equity awards and associated cash payments, as a result of the Separation,

partially offset by:

- lower employee benefit costs due to the termination of the defined benefit pension plan for U.S. employees.

Six months ended June 30, 2013 vs. six months ended July 1, 2012

R&D expenses decreased by $9 million, or 5%, in the first six months of 2013 compared to the first six months of 2012, primarily as a result of:

- the nonrecurrence of depreciation expense incurred in 2012 related to the closing of an R&D facility in the U.K.; and
- lower employee benefit costs due to the termination of the defined benefit pension plan for U.S. employees,

partially offset by:

- additional one-time costs of $4 million due to the accelerated vesting of certain Pfizer equity awards and associated cash payments, as a result of the Separation.

Amortization of intangible assets

	Three Months Ended June 30,	July 1,	%	Six Months Ended June 30,