

Financial Section

Contents

Financial Review	
Description of Merck's Business	20
Overview	20
Competition and the Health Care Environment	22
Operating Results	22
Selected Joint Venture and Affiliate Information	29
Capital Expenditures	31
Analysis of Liquidity and Capital Resources	31
Financial Instruments Market Risk Disclosures	32
Critical Accounting Policies and Other Matters	33
Recently Issued Accounting Standards	37
Cautionary Factors That May Affect Future Results	37
Cash Dividends Paid per Common Share	38
Common Stock Market Prices	38
Condensed Interim Financial Data	38
Consolidated Statement of Income	39
Consolidated Statement of Retained Earnings	39
Consolidated Statement of Comprehensive Income	39
Consolidated Balance Sheet	40
Consolidated Statement of Cash Flows	41
Notes to Consolidated Financial Statements	42
Management's Report	66
Audit Committee's Report	66
Report of Independent Registered Public Accounting Firm	67
Compensation and Benefits Committee's Report	67
Selected Financial Data	68

Financial Review

Description of Merck's Business

Merck is a global research-driven pharmaceutical company that discovers, develops, manufactures and markets a broad range of innovative products to improve human and animal health, directly and through its joint ventures. Merck sells its products primarily to drug wholesalers and retailers, hospitals, clinics, government agencies and managed health care providers such as health maintenance organizations and other institutions. The Company's professional representatives communicate the effectiveness, safety and value of our products to health care professionals in private practice, group practices and managed care organizations.

Overview

In December 2005, Merck unveiled a plan to reclaim its leadership position in the pharmaceutical industry. As part of the strategy, Merck is focusing on improving its research and development (R&D) productivity by focusing on select therapeutic areas, implementing a new commercial model that will deliver greater value to customers, and reducing its overall cost structure company-wide.

Merck's new R&D model is designed to increase productivity and improve the probability of success by prioritizing the Company's R&D resources on nine priority disease areas – Alzheimer's disease, atherosclerosis, cardiovascular disease, diabetes, novel vaccines, obesity, oncology, pain and sleep disorders. These therapeutic areas were carefully chosen based on a set of criteria including unmet medical needs, scientific opportunity and commercial opportunity. Within these therapeutic areas, Merck will commit resources to achieve research breadth and depth and to develop best-in-class targeted and differentiated products that are valued highly by patients, payers and physicians.

The Company will also make focused investments to pursue specific mechanisms in the following selected disease areas: antibiotics, antifungals, antivirals (hepatitis C virus, human immunodeficiency virus), asthma, chronic obstructive pulmonary disease, neurodegeneration, ophthalmology, osteoporosis, schizophrenia and stroke. In addition, the Company will capitalize on selected opportunities outside these areas by continuing to commercialize attractive clinical development candidates in the pipeline and by pursuing appropriate external licensing opportunities.

Merck's late-stage pipeline is showing strong progress with three Biologics License Application (BLA) submissions to the U.S. Food and Drug Administration (FDA) in 2005, one New Drug Application (NDA) already filed with the FDA in 2006, two additional FDA filings anticipated in 2006, and an expected five programs in Phase III by the first quarter of 2006.

The three FDA submissions in 2005 include *Gardasil*, a breakthrough vaccine to help prevent cervical cancer, the second leading cause of cancer deaths in women worldwide; *Zostavax*, a vaccine to reduce the incidence of shingles; and *RotaTeq*, a pediatric vaccine to prevent rotavirus gastroenteritis, a leading cause of diarrhea in infants and young children, which leads to nearly 500,000 deaths worldwide each year. On February 3, 2006, Merck announced the approval by the FDA of *RotaTeq*. In addition, on February 7, 2006, Merck announced that the FDA has accepted the BLA for *Gardasil* and granted the vaccine priority review designation.

On February 15, 2006, Merck announced that the NDA filed with the FDA for *Januvia* (the proposed trademark for the compound known as MK-0431), a novel mechanism for the treatment of type 2 diabetes, was accepted for standard review. Merck also anticipates two additional FDA filings in 2006: vorinostat (the generic name for the suberoylanilide hydroxamic acid (SAHA) compound), a histone deacetylase inhibitor for cancer; and MK-0517, an intravenous prodrug of aprepitant to treat chemotherapy-induced nausea and vomiting.

To improve its commercial selling model, Merck will continue to streamline and restructure its marketing and sales operations worldwide to improve their effectiveness and generate greater efficiencies. In the United States, the Company already has reduced the number of sales representatives promoting the same product by 50 percent versus historical levels. In addition, Merck will place more emphasis on active engagement with key opinion leaders to accelerate the development and diffusion of scientific information and devote additional resources to utilizing technology and demonstrating product value to physicians, as well as payers and consumers who have increasing influence on prescription decisions. In the United States, this approach has already resulted in considerable productivity improvements in pilot programs and is expected to lower the Company's spending per brand by 15 to 20 percent by 2010, while maximizing sales performance. To provide additional support to its upcoming vaccine launches, in the United States Merck is redeploying 1,500 sales representatives who currently promote its major in-line products to support the launch of new vaccines.

In November 2005, the Company announced the first phase of a global restructuring program designed to reduce the Company's cost structure, increase efficiency, and enhance competitiveness. The initial steps will include the implementation of a new supply strategy by the Merck Manufacturing Division, which is intended to create a leaner, more cost-effective and customer-focused manufacturing model over the next three years. As part of this program, Merck plans to sell or close five manufacturing sites and two preclinical sites by the end of 2008, and eliminate approximately 7,000 positions company-wide. As of December 31, 2005, approximately 1,100 positions throughout the Company had been eliminated. Merck incurred \$401.2 million in costs associated with the global restructuring program which were comprised of

\$205.4 million of separation costs and \$195.8 million of accelerated depreciation and asset impairment costs.

The manufacturing facilities included in this action are: Ponders End, United Kingdom; Okazaki, Japan; Kirkland, Canada; Albany, Georgia and Danville, Pennsylvania. The two preclinical sites are in Okazaki and Menuma, Japan. The Company will incur significantly larger accelerated depreciation charges during 2006 associated with these actions. The asset impairment charge was associated with the abandonment of certain fixed assets that will no longer be used in the business as a result of these restructuring actions. The Company also plans to close its basic research center in Terlings Park, United Kingdom, and incurred additional accelerated depreciation costs of \$103.1 million during 2005 with respect to this site.

Additional charges of approximately \$800 million to \$1 billion are expected to be recorded during 2006, based on estimated time of completion, as the sales/closures of the facilities previously discussed occur. Merck expects its cost reduction program to yield cumulative pre-tax savings of \$4.5 to \$5.0 billion from 2006 through 2010.

The American Jobs Creation Act (AJCA), signed into law in October 2004, created temporary incentives through December 31, 2005 for U.S. multinationals to repatriate accumulated income earned outside of the United States as of December 31, 2002. In connection with the AJCA, the Company repatriated \$15.9 billion during 2005, and as a result, recorded an income tax charge of \$766.5 million. This charge was partially offset by a \$100 million benefit associated with the decision to implement certain tax planning strategies.

As previously disclosed, on September 30, 2004, Merck announced a voluntary worldwide withdrawal of *Vioxx*, its arthritis and acute pain medication. As a result, the Company recorded a charge to pre-tax income of \$726.2 million, or \$552.6 million after tax adjustment to net income, in the third quarter 2004. This did not include charges for future legal defense costs. The *Vioxx* withdrawal process was completed during 2005 and the costs associated with the withdrawal were in line with the original amounts recorded by the Company in 2004.

As of December 31, 2004, the Company had established a reserve of \$675 million solely for its future *Vioxx* legal defense costs. During 2005, the Company spent \$285 million in the aggregate in *Vioxx* legal defense costs worldwide. In the fourth quarter of 2005, the Company recorded a charge of \$295 million to increase the reserve solely for its future legal defense costs related to *Vioxx* to \$685 million at December 31, 2005. This reserve is based on certain assumptions and is the best estimate of the amount that the Company believes, at this time, it can reasonably estimate will be spent through 2007.

Earnings per common share assuming dilution for 2005 were \$2.10, including the impact of the global restructuring program of \$0.12 per share, the net tax charge primarily associated with the AJCA of \$0.31 per share and additional reserves established solely for future legal defense costs for *Vioxx* litigation (as discussed above).

Competition and the Health Care Environment

The markets in which the Company conducts its business are highly competitive and often highly regulated. Global efforts toward health care cost containment continue to exert pressure on product pricing and access.

In the United States, the government expanded health care access by enacting the Medicare Prescription Drug Improvement and Modernization Act of 2003, which was signed into law in December 2003. Prescription drug coverage began on January 1, 2006. This new benefit supports the Company's goal of improving access to medicines by expanding insurance coverage, while preserving market-based incentives for pharmaceutical innovation. At the same time, the benefit will ensure that prescription drug costs will be controlled by competitive pressures and by encouraging the appropriate use of medicines.

In addressing cost-containment pressure, the Company has made a continuing effort to demonstrate that its medicines can help save costs in overall patient health care. In addition, pricing flexibility across the Company's product portfolio has encouraged growing use of its medicines and mitigated the effects of increasing cost pressures.

Outside the United States, in difficult environments encumbered by government cost-containment actions, the Company has worked in partnership with payers on allocating scarce resources to optimize health care outcomes, limiting the potentially detrimental effects of government policies on sales growth and access to innovative medicines and vaccines, and to support the discovery and development of innovative products to benefit patients. The Company also is working with governments in many emerging markets in Eastern Europe, Latin America and Asia to encourage them to increase their investments in health and thereby improve their citizens' access to medicines. Countries within the European Union (EU), recognizing the economic importance of the research-based pharmaceutical industry and the value of innovative medicines to society, are working with industry representatives and the European Commission on proposals to complete the "Single Market" in pharmaceuticals and improve the competitive climate through a variety of means including market deregulation.

The Company is committed to improving access to medicines and enhancing the quality of life for people around the world. The African Comprehensive HIV/AIDS Partnerships (ACHAP) in Botswana, a partnership between the government of Botswana, the Bill & Melinda Gates Foundation and The Merck Company Foundation/Merck & Co., Inc. is supporting Botswana's response to HIV/AIDS through a comprehensive and sustainable approach to HIV prevention, care, treatment and support. In May 2005, the Company initiated a similar partnership with the People's Republic of China (focused initially in Sichuan Province) to help strengthen China's response to the HIV epidemic.

To further catalyze access to HIV medicines in developing countries, under price reduction guidelines that the Company announced in 2001, Merck makes no profit on the sale of its current HIV/AIDS medicines in the world's poorest countries and those hardest hit by the pandemic, and offers its HIV/AIDS medicines at significantly reduced prices to medium-income countries. By the end of 2005, more than 475,000 patients in more than 75 developing countries were being treated with

antiretroviral regimens containing either *Crixivan* or *Stocrin*. Through these and other actions, Merck is working independently and with partners in the public and private sectors alike to focus on the most critical barriers to access to medicines in the developing world: the need for sustainable financing, increased international assistance and additional investments in education, training and health infrastructure and capacity in developing countries.

There has been an increasing amount of focus on privacy issues in countries around the world, including the United States and the EU. In the United States and the EU, governments have pursued legislative and regulatory initiatives regarding privacy, including federal privacy regulations and recently enacted state privacy laws concerning health and other personal information, which have affected the Company's operations.

Although no one can predict the outcome of these and other legislative, regulatory and advocacy initiatives, the Company is well-positioned to respond to the evolving health care environment and market forces.

As certain of the Company's products face patent expiration, Merck will consider entering into authorized generic agreements which would allow the Company to benefit when these medicines become available in generic form.

The Company anticipates that the worldwide trend toward cost-containment will continue, resulting in ongoing pressures on health care budgets. As the Company continues to successfully launch new products, contribute to health care debates and monitor reforms, its new products, policies and strategies should enable it to maintain a strong position in the changing economic environment.

Operating Results

Sales

Worldwide sales for 2005 decreased 4% in total over 2004, reflecting a decrease of 7% related to the voluntary worldwide withdrawal of *Vioxx*, offset by revenue growth in all other products of 3%. This growth reflects a 1% favorable effect from foreign exchange, a 1% favorable effect from price changes and a volume increase of 1%. Sales performance over 2004 reflects strong growth of *Singulair*, a once-a-day oral medicine indicated for the treatment of chronic asthma and the relief of symptoms of allergic rhinitis, *Cancidas* for antifungal infections, *Cozaar/Hyzaar* for high blood pressure and higher revenues from the Company's relationship with AstraZeneca LP (AZLP) primarily driven by *Nexium*. Sales growth was offset by declining sales of *Zocor* for high cholesterol.

Domestic sales declined 5%, reflecting the unfavorable effect from the voluntary worldwide withdrawal of *Vioxx* of 7% which was offset by revenue growth in all other products of 2%. Foreign sales declined 2% also reflecting the unfavorable effect from the voluntary worldwide withdrawal of *Vioxx* of 6% and was offset by revenue growth in all other products of 4%. Foreign sales represented 42% of total sales in 2005.

Worldwide sales for 2004 increased 2% in total over 2003, reflecting a 3% favorable effect from foreign exchange, a 1% favorable effect from price changes and a volume decline of 2%. Sales for 2004 were unfavorably impacted by the voluntary worldwide withdrawal of *Vioxx*. Foreign sales represented 41% of total sales for 2004.

Sales⁽¹⁾ of the Company's products were as follows:

(\$ in millions)	2005	2004	2003
Zocor	\$ 4,381.7	\$ 5,196.5	\$ 5,011.4
Fosamax	3,191.2	3,159.7	2,676.6
Cozaar/Hyzaar	3,037.2	2,823.7	2,486.0
Singulair	2,975.6	2,622.0	2,009.4
Proscar	741.4	733.1	605.5
Primaxin	739.6	640.6	628.9
Vasotec/Vaseretic	623.1	719.2	763.7
Cosopt/Trusopt	617.2	558.8	484.4
Candidas	570.0	430.0	275.7
Maxalt	348.4	309.9	324.2
Propecia	291.9	270.2	239.0
Vioxx	—	1,489.3	2,548.8
Vaccines/Biologicals	1,103.3	1,036.1	1,056.1
Other	3,391.3	2,949.5	3,376.2
	\$22,011.9	\$22,938.6	\$22,485.9

⁽¹⁾ Presented net of discounts and returns.

The Company's products include therapeutic and preventive agents, generally sold by prescription, for the treatment of human disorders. Among these are *Zocor*, Merck's largest-selling atherosclerosis product; *Fosamax* and *Fosamax Plus D*, Merck's osteoporosis products for treatment and, in the case of *Fosamax*, prevention of osteoporosis; *Cozaar/Hyzaar* and *Vasotec*, the Company's most significant hypertension/heart failure products; *Singulair*, a leukotriene receptor antagonist respiratory product for the treatment of chronic asthma and for the relief of symptoms of allergic rhinitis; *Proscar*, a urology product for the treatment of symptomatic benign prostate enlargement; *Primaxin* and *Candidas*, antibacterial/antifungal products; *Cosopt* and *Trusopt*, the largest-selling ophthalmological products; *Maxalt*, an acute migraine product; *Propecia*, a product for the treatment of male pattern hair loss; and vaccines/biologicals, which include *Varivax*, a live virus vaccine for the prevention of chickenpox, *M-M-R II*, a pediatric vaccine for measles, mumps and rubella, *Pneumovax*, a vaccine for the prevention of pneumococcal disease, and *Recombivax HB*, a vaccine for the prevention of hepatitis B.

Other primarily includes sales of other human pharmaceuticals, pharmaceutical and animal health supply sales to the Company's joint ventures and revenue from the Company's relationship with AZLP, primarily relating to sales of *Nexium* and *Prilosec*. Revenue from AZLP was \$1.7 billion, \$1.5 billion, and \$1.9 billion in 2005, 2004 and 2003, respectively.

Singulair, Merck's once-a-day oral respiratory medicine indicated for the treatment of chronic asthma and the relief of symptoms of allergic rhinitis, continued its strong performance in 2005, reflecting the continued demand for asthma medications and the new indication for perennial allergic rhinitis in the United States. Total 2005 sales of *Singulair* were \$3.0 billion, an increase of 13% over 2004.

In December 2005, Merck announced a U.S. label change for *Singulair* incorporating the positive results from a clinical study that showed children with asthma taking *Singulair* had

similar growth rates as children taking placebo. In the same study, children taking an inhaled steroid had slower growth rates than children on either *Singulair* or placebo.

In 2005, the FDA approved two new indications for *Singulair* and accepted for review the supplemental NDA for *Singulair* for use in the prevention of exercise-induced bronchospasm (EIB) in patients 15 years of age or older. In December 2005, Merck received an approvable letter from the FDA for the EIB indication for *Singulair*. Merck is currently in discussions with the FDA to determine what additional data or revisions to its application will be necessary to obtain approval for this indication.

In August 2005, Merck announced that the FDA had approved *Singulair* for the symptoms of perennial allergic rhinitis, or year-round allergies, in adults and children six months of age and older.

In January 2005, Merck announced that a new indication for *Singulair* to treat symptoms of seasonal allergic rhinitis in asthmatic patients was launched in the EU. This new indication has been launched in several countries in the EU and is the only respiratory therapy approved for the treatment of both asthma and seasonal allergic rhinitis in asthmatic patients. An indication for *Singulair* for the treatment of seasonal allergic rhinitis was granted in the United States in late 2002.

Merck expects to seek new indications for *Singulair* for acute asthma in 2007 and for respiratory syncytial bronchiolitis in 2008.

Global sales for *Cozaar*, and its companion agent *Hyzaar* (a combination of *Cozaar* and the diuretic hydrochlorothiazide), for the treatment of hypertension were strong in 2005, reaching \$3.0 billion, an 8% increase over 2004.

Cozaar and *Hyzaar* compete in the fastest-growing class in the antihypertensive market, angiotensin II antagonists (AIIA). *Cozaar/Hyzaar* continues to be the largest-selling branded AIIA in Europe and the second most frequently prescribed AIIA in the United States.

In early October 2005, the FDA approved a new tablet, *Hyzaar* 100/12.5 mg, a new dosage offering the once-daily efficacy of *Cozaar* 100 mg with a low-dose diuretic. This new formulation addresses the need for titration flexibility as an intermediate step between *Cozaar* 100 mg and *Hyzaar* 100/25 mg. Filings for this new formulation outside the United States have occurred throughout 2005, including in the United Kingdom, Germany, France and Italy.

In April 2005, the FDA approved a new indication for *Hyzaar*, based on the Losartan Intervention for Endpoint Reduction (LIFE) trial, for reduction in the risk of stroke in patients with hypertension and left ventricular hypertrophy (LVH), but there is evidence that this benefit does not apply to black patients.

Global sales for *Fosamax*, the most prescribed medicine worldwide for the treatment of postmenopausal, male and glucocorticoid-induced osteoporosis, were \$3.2 billion in 2005, an increase of 1% over 2004. In 2005, Merck enhanced its osteoporosis franchise with the addition of *Fosamax Plus D*, a new product that provides the proven power of *Fosamax* to reduce the risk of both hip and spine fractures plus the assurance of offering a minimum vitamin D intake consistent with the recommended guidelines, which became available in the United States early in 2005. On August 25, 2005, the

European Commission granted marketing authorization for this product, which is known in Europe as *Fosavance*. The approval of *Fosamax Plus D* will not extend the patent for *Fosamax*. *Fosamax Plus D* is an important innovation in osteoporosis treatment that will help satisfy an unmet medical need. An estimated 70% of women aged 51-70 and almost 90% of women over age 70 are not getting adequate intake of vitamin D. Vitamin D insufficiency is associated with reduced calcium absorption, bone loss and increased risk of fracture.

Additionally, new one-year extension results of the U.S. FACT (*Fosamax* Actonel Comparison Trial) study showed that *Fosamax* delivered significantly greater increases in bone mineral density (BMD) at both the hip and spine than risedronate over two years. The increases in BMD seen with *Fosamax* were even greater compared to risedronate at year two than year one. *Fosamax* also delivered superior reductions in bone turnover than risedronate, with a significantly greater effect after only three months of treatment.

As previously disclosed, on January 28, 2005, the U.S. Court of Appeals for the Federal Circuit in Washington, D.C. found the Company's patent claims for once-weekly administration of *Fosamax* to be invalid. The Company exhausted all options to appeal this decision in 2005. Based on the Court of Appeals' decision, *Fosamax* will lose its market exclusivity in the United States in February 2008 and the Company expects a significant decline in U.S. *Fosamax* sales after that time. Additionally, sales of *Fosamax* in 2005 have declined in certain countries in which the patent has already expired.

Zocor, Merck's statin for modifying cholesterol, achieved worldwide sales of \$4.4 billion in 2005, a decrease of 16% from 2004. Sales of *Zocor* were affected by increased competition in the United States and generic competition in most markets outside of the United States. Currently, *Zocor* is available for 93 percent of managed care lives; and 100 percent of the targeted managed care contracts have been renewed through 2006. In June 2006, *Zocor* will lose its market exclusivity in the United States and the Company expects a significant decline in U.S. *Zocor* sales after that time. Global sales of *Zocor* are estimated to be \$2.3 to \$2.6 billion for full-year 2006.

Other products experiencing growth in 2005 include *Cancidas* to treat certain life-threatening fungal infections, *Primaxin* for treatment of bacterial infections, *Cosopt* to treat glaucoma, *Emend* for prevention of acute and delayed nausea

and vomiting associated with moderately and highly emetogenic cancer chemotherapy, *Maxalt* to treat migraine pain, *Invanz* for the treatment of selected moderate to severe infection in adults and *Propecia* for male pattern hair loss. Also contributing to Merck's total sales in 2005 was revenue resulting from the Company's relationship with AZLP, primarily relating to sales of *Nexium*.

Global sales of *Cancidas*, a once-daily antifungal medicine, were strong, reaching \$570.0 million, an increase of 33% over 2004. The strong results were driven by the new indication received from the FDA in October 2004, as an empirical therapy for presumed fungal infections in febrile neutropenic patients.

Proscar, Merck's urology product for the treatment of symptomatic benign prostate enlargement, will go off patent and lose its market exclusivity in the United States in June 2006. As a result, the Company expects a significant decline in U.S. *Proscar* sales after that time. The basic patent for *Proscar* also covers *Propecia*, however, *Propecia* is protected by additional patents which expire in October 2013.

As reported by the Merck/Schering-Plough partnership, global sales of *Zetia* and *Vytorin* in the aggregate reached \$2.4 billion. Global sales of *Zetia* (marketed as *Ezetrol* outside the United States), the cholesterol-absorption inhibitor, reached \$1.4 billion in 2005, a 33% increase over 2004. Global sales of *Vytorin* (marketed as *Inegy* outside the United States) reached \$1.0 billion in 2005. *Vytorin* is the first single tablet cholesterol treatment to provide LDL cholesterol lowering through the dual inhibition of cholesterol production and absorption. *Vytorin* was approved in the United States in July 2004 and is demonstrating consistent growth.

In November 2005, the Merck/Schering-Plough partnership announced the commencement of patient enrollment in its large-scale, clinical outcomes trial, IMPROVE-IT (Improved Reduction of Outcomes: *Vytorin* Efficacy International Trial). This trial will evaluate the effectiveness of *Vytorin* compared to *Zocor* (simvastatin) alone in treating approximately 10,000 high risk patients with coronary artery disease presenting with acute coronary syndromes. Clinical trial sites are opening throughout North America and Europe.

The Company records the results from its interest in the Merck/Schering-Plough partnership in Equity income from affiliates.

Costs, Expenses and Other

(\$ in millions)	2005	Change	2004	Change	2003
Materials and production	\$ 5,149.6	+ 4%	\$ 4,959.8	+12%	\$ 4,436.9
Marketing and administrative	7,155.5	- 1%	7,238.7	+17%	6,200.3
Research and development	3,848.0	- 4%	4,010.2	+22%	3,279.9
Restructuring costs	322.2	*	107.6	-45%	194.6
Equity income from affiliates	(1,717.1)	+70%	(1,008.2)	*	(474.2)
Other (income) expense, net	(110.2)	-68%	(344.0)	+69%	(203.2)
	\$14,648.0	- 2%	\$14,964.1	+11%	\$13,434.3

* 100% or greater.

Materials and Production

In 2005, materials and production costs increased 4%, compared to a 4% decline in sales. Included in the increase is a 1% unfavorable effect from inflation and a 3% increase in volume. The increase is attributable to \$177.1 million recorded in 2005 primarily related to the global restructuring program. Of this, \$111.2 million represents impairment charges associated with the abandonment of certain fixed assets that will no longer be used in the business as a result of these restructuring actions. The remaining \$65.9 million represents accelerated depreciation associated with Merck's plan to sell or close five of its owned manufacturing facilities (see Note 4). The variance in these costs relative to the sales decline reflects the impact of the items noted above, as well as the unfavorable effect on sales associated with the voluntary worldwide withdrawal of *Vioxx* in 2004.

In 2004, materials and production costs increased 12% compared to a 2% sales growth rate. Included in the increase is a 2% unfavorable effect from inflation, 2% unfavorable effect from exchange and an 8% increase in volume. The increase in these costs relative to the sales growth reflects the unfavorable effect associated with the voluntary worldwide withdrawal of *Vioxx* and the impact of changes in product mix. Gross margin was 76.6% in 2005 compared to 78.4% in 2004 and 80.3% in 2003. The 2005 restructuring charge noted above and the impact of the voluntary worldwide withdrawal of *Vioxx* had an unfavorable effect on the gross margin in 2005 and 2004.

Marketing and Administrative

In 2005, marketing and administrative expenses decreased 1%. Included in the decrease is a 4% unfavorable effect from inflation, a 1% unfavorable effect from exchange, and a 6% decline in volume. The decrease was primarily due to costs recorded in 2004 of \$141.4 million for the voluntary worldwide withdrawal of *Vioxx* (see Note 3) and \$604 million for the establishment of a reserve solely for legal defense costs for *Vioxx* litigation. Partially offsetting the decrease was an additional reserve of \$295 million for *Vioxx* legal defense costs recorded in the current year, as well as costs required to prepare for the launch of three new investigational vaccines, maintaining activities in support of Merck's in-line products and rolling out new product indications and critical outcome data globally.

In 2004, marketing and administrative expenses increased 17%. Included in the increase is a 3% unfavorable effect from inflation, a 4% unfavorable effect from exchange, and a 10% increase in volume. The increase in 2004 reflects the impact of an additional \$604 million reserve recorded solely for future legal defense costs for *Vioxx* litigation and \$141.4 million of estimated costs to undertake the voluntary worldwide withdrawal of *Vioxx*.

Research and Development

Research and development expenses decreased 4% in 2005. Included in the decrease is a 2% unfavorable effect from inflation and a 6% decline in volume. Included in 2005 are accelerated depreciation costs of \$103.1 million related to the closure of the basic research center located in Terlings Park, United Kingdom, as well as \$18.7 million associated with plans to sell

or close two pre-clinical sites by the end of 2008 in Okazaki and Menuma, Japan in connection with the global restructuring program. In addition, the decrease reflects the 2004 impact of \$225.0 million of licensing expense for the initial payments for certain disclosed research collaborations and \$125.5 million of acquired research expense from the acquisition of Aton Pharma, Inc. in 2004. Partially offsetting the decrease is an 8% increase in other research and development activities in support of Merck's pipeline.

In December 2005, Merck submitted a BLA to the FDA for *Gardasil* [quadrivalent human papillomavirus (types 6, 11, 16, 18) recombinant vaccine], the Company's vaccine to protect against four types of human papillomavirus (HPV); types 16 and 18, which account for an estimated 70% of cervical cancer cases, and types 6 and 11, which account for an estimated 90% of genital warts cases. Cervical cancer results in approximately 300,000 deaths worldwide each year. In the United States, an estimated 10,000 new cases of cervical cancer were diagnosed in 2005 and there were approximately 3,700 deaths. There are an estimated 86 million women in the United States and the EU between the ages of 9 and 26, the expected age range for the initial indication of *Gardasil*.

In October 2005, Merck presented results of the FUTURE II study, a Phase III efficacy study for *Gardasil* in 12,167 women aged 16 to 26 years. These data, presented at the Infectious Diseases Society of America (IDSA) annual meeting, reported that *Gardasil* prevented 100% of high-grade cervical pre-cancers and non-invasive cervical cancers (CIN 2/3 or AIS) associated with HPV types 16 and 18. The primary analysis compared *Gardasil* to placebo in women who were not infected with HPV 16 and 18 at enrollment, who remained free of infection through the completion of the seven-month vaccination regimen, and who received all three doses of *Gardasil*. Women were followed for an average of two years after enrollment. No cases of CIN 2/3 or AIS were observed in the vaccine group (n=5,301) compared to 21 cases in the placebo group (n=5,258). CIN (cervical intraepithelial neoplasia) 2 is a moderate-grade lesion of the cervix while CIN 3 represents both high-grade lesions and CIS (carcinoma in situ), the immediate pre-cursor to invasive squamous cell cervical cancer. AIS is the early development of adenocarcinoma (or glandular cancer) of the cervix.

A secondary analysis, also presented at IDSA, evaluated the incidence of CIN 2/3 and AIS starting 30 days after the administration of the first dose in all of the women in the primary analysis group, as well as women who may have become infected with HPV 16 or HPV 18 during the vaccination period. Women who may have violated the protocol in significant ways (for example, by missing certain protocol visits) were also included. On average, these women were followed for approximately two years from the time of enrollment. In this group, *Gardasil* reduced the risk of developing high-grade cervical pre-cancer and non-invasive cervical cancer (CIN 2/3, or AIS) associated with HPV 16 and 18 by 97% (n=5,736); one case was observed in the vaccine group compared to 36 in the placebo group (n=5,766).

On February 7, 2006, Merck announced that the FDA accepted the BLA for *Gardasil* and that the investigational cervical cancer vaccine will be given priority review by the agency. A priority designation is intended for products that address unmet

medical needs. Under the Prescription Drug User Fee Act, for BLAs filed in 2005, the FDA's goal is to review and act on BLAs designated as priority review within six months of receipt. The FDA has informed Merck that the review goal date is June 8, 2006. Since the submission to the FDA in December, Merck has also submitted applications for *Gardasil* to additional regulatory agencies including those in the EU, Australia, Mexico, Brazil, Argentina, Taiwan and Singapore.

In February 2005, the Company announced that it and GlaxoSmithKline (GSK) entered into a cross-license and settlement agreement for certain patent rights related to HPV vaccines. Pursuant to the agreement, GSK will receive an upfront payment and royalties from the Company based upon sales of *Gardasil*, upon development and launch. The agreement resolves competing intellectual property claims related to the Company's and GSK's vaccine candidates. In addition, in 1995, Merck entered into a license agreement and collaboration with CSL Limited relating to technology used in *Gardasil*. *Gardasil* is also the subject of other third-party licensing agreements.

In September 2005, the FDA approved *ProQuad* [Measles, Mumps, Rubella, and Varicella (Oka/Merck) Virus Vaccine Live]. *ProQuad* is a combination vaccine for simultaneous vaccination against measles, mumps, rubella and varicella in children 12 months to 12 years of age. *ProQuad* combines two established Merck vaccines, *M-M-R II* [Measles, Mumps, Rubella Virus Vaccine Live] and *Varivax* [Varicella Virus Vaccine Live (Oka/Merck)]. In March, the U.S. Centers for Disease Control (CDC) announced that rubella, or German measles, was no longer a public health threat in the United States. At this time, Merck is the sole manufacturer of vaccines that protect against rubella, as well as measles, mumps and varicella, in the United States.

In August 2005, Merck's vaccine for hepatitis A, *Vaqta*, was approved by the FDA for use in children 12 months of age and older. Previously, *Vaqta* was approved for use in people two years of age and older.

On February 3, 2006, Merck announced the approval by the FDA of *RotaTeq*, its pentavalent vaccine to protect against rotavirus gastroenteritis. *RotaTeq* is an oral, three-dose liquid vaccine that contains five human serotypes: G1, G2, G3, G4 and P1. Merck has also submitted applications for licensure of *RotaTeq* in Australia, Mexico, Canada and countries in Asia and Latin America and, through the Sanofi Pasteur MSD joint venture, in the EU.

In June 2005, the FDA accepted for standard review the BLA for *Zostavax*, Merck's investigational vaccine for the prevention of herpes zoster, commonly known as "shingles," in adults 60 years of age or older. Sanofi Pasteur MSD has submitted an application for licensure of *Zostavax* in the EU, and Merck has also submitted applications for licensure of *Zostavax* in Australia, Canada and in countries in Asia and Latin America. In February 2006, the FDA extended its review by three months until late May.

In May 2005, Merck announced the results of a Phase II open label study of vorinostat, an investigational oral suberoyl-

lanilide hydroxamic acid, a new class of anti-tumor agents that inhibits histone deacetylase. In the study, eight of the 33 patients with advanced, refractory cutaneous T-cell lymphoma (CTCL) experienced partial responses (physician assessment of >50 percent reduction in overall disease burden), the primary endpoint of the study. These results were presented at the annual meeting of the American Society of Clinical Oncology in Orlando, Florida.

CTCL, a type of non-Hodgkin's lymphoma, is a slow-growing form of cancer in which some of the body's white blood cells known as T-lymphocytes or T-cells become malignant. CTCL affects 20,000 patients in the United States, with another 1,500 new cases reported each year.

In September 2005, Merck presented two studies of Phase II data on the Company's DPP-4 inhibitor, *Januvia*, the proposed trademark for MK-0431 (sitagliptin), a potential new approach in the treatment of type 2 diabetes, at the 41st annual meeting of the European Association for the Study of Diabetes (EASD). The studies showed that *Januvia* significantly improved glycemic control in patients with primarily mild-to-moderate hyperglycemia and in patients with more severe hyperglycemia, as compared with placebo. In these studies, *Januvia* was generally well-tolerated. On February 15, 2006, Merck announced that the NDA for *Januvia* was accepted for standard review by the FDA. Merck expects FDA action on the NDA by mid-October 2006.

As announced in December 2005, Merck is also developing MK-0431A, a combination of *Januvia* and metformin for the treatment of type 2 diabetes.

Also announced in December 2005, Merck has, or is on track to have by the first quarter 2006, promising drugs in Phase III development for diabetes, insomnia, high cholesterol, heart disease, and HIV/AIDS. The Phase III candidates include the following:

Gaboxadol, a unique mechanism from Merck's alliance with H. Lundbeck A/S, has the potential to provide benefits beyond existing therapies with respect to sleep quality and next-day effects.

MK-0524A and MK-0524B hold significant promise in further addressing the critical need for lipid/cholesterol management. MK-0524A represents a novel approach in treating HDL-C and triglycerides, combining Merck's own extended release niacin with MK-0524. MK-0524B combines MK-0524A with the proven benefits of simvastatin to potentially reduce the risk of coronary heart disease beyond what statins provide alone.

MK-0518 is expected to be the first in a new class of anti-retrovirals that is effective in inhibiting integrase, an enzyme necessary for the survival of HIV. On February 9, 2006, Merck announced interim results from a dose-ranging Phase II trial of MK-0518 (n=167) which showed that the oral investigational medication at all three doses studied (200 mg, 400 mg and 600 mg orally twice daily) in combination with optimized background therapy (OBT) had greater antiretroviral activity than placebo with OBT. Study results also showed that MK-0518 in combination with OBT was generally well-tolerated in these patients

with advanced HIV infection who were failing antiretroviral therapy (ART), who had viruses resistant to at least one drug of each of the three available classes of oral ARTs and who had limited active ARTs as options for treatment. The results were presented at the 13th Annual Conference on Retroviruses and Opportunistic Infections.

Merck continues to remain focused on augmenting its internal research efforts by capitalizing on growth opportunities, ranging from research collaborations, preclinical and clinical compounds and technology transactions that will drive both near- and long-term growth. The Company completed 44 transactions in 2005 across a broad range of therapeutic categories including neuroscience, obesity and oncology, as well as early-stage technology transactions. Merck is currently evaluating more than 40 other opportunities, and is actively monitoring the landscape for a range of targeted acquisitions that meet the Company's strategic criteria. Highlights for the year include:

In May 2005, Merck and BioXcell entered into an agreement to develop new treatments for sepsis and other inflammatory disorders.

In June 2005, Vical Incorporated exercised three options under a 2003 amendment to an existing research collaboration and licensing agreement, granting Merck rights to use Vical's patented non-viral gene delivery technology in cancer vaccine applications.

Merck and Vertex Pharmaceuticals Incorporated announced in June the initiation of an additional Phase I clinical study with VX-680, a small molecule inhibitor of Aurora kinases. Aurora kinases are implicated in the onset and progression of human leukemias.

Sumitomo Pharmaceuticals Co., Ltd. (Sumitomo) and Merck signed an agreement in June to collaborate on SM13496 (lurasidone), an atypical antipsychotic compound currently in Phase II development for the treatment of schizophrenia, one of the most chronic and disabling of the severe mental illnesses. Under the agreement, Sumitomo has granted Merck, through an affiliate, an exclusive license for SM13496 in all parts of the world except for Japan, China, Korea and Taiwan.

In June 2005, Merck announced an agreement with Metabasis Therapeutics to research, develop and commercialize novel small molecule therapeutics with the potential to treat several diseases, including type 2 diabetes, hyperlipidemia and obesity, by activation of an enzyme in the liver called AMP-activated Protein Kinase.

In July 2005, Merck and Geron Corporation announced an agreement to develop a cancer vaccine against telomerase. Telomerase is an enzyme, active in most cancer cells, that maintains telomere length at the ends of chromosomes. This activity allows the cancer to grow and metastasize over long periods of time.

In September 2005, FoxHollow Technologies and Merck announced the formation of a novel pharmacogenomics collaboration. The collaboration will focus on analyzing atherosclerotic plaque removed from patient arteries as a means of

identifying new biomarkers of atherosclerotic disease progression for use in the development of cardiovascular compounds in Merck's pipeline. The agreement includes a research collaboration of up to three years.

In October 2005, Agensys, Inc., a cancer biotechnology company, and Merck announced that they have formed a global alliance to jointly develop and commercialize AGS-PSCA, Agensys' fully human monoclonal antibody (MAB) to Prostate Stem Cell Antigen (PSCA). The agreement grants Merck worldwide rights to AGS-PSCA and an exclusive license to PSCA, a proprietary target, as well as rights to other therapeutic and diagnostic products developed under the alliance.

Also in October 2005, Merck and Bristol-Myers Squibb (BMS) jointly announced that they have signed separate license agreements with the International Partnership for Microbicides to develop new antiretroviral compounds as potential microbicides to protect women from HIV. This agreement marks the first time a pharmaceutical company has licensed an anti-HIV compound for development as a microbicide when the class of drugs is so early in development. The compounds are part of a new class of antiretrovirals known as "entry inhibitors." Some of the compounds bind directly to HIV; others bind to the CCR5 receptor. They are designed to prevent HIV from efficiently entering host cells, thus preventing infection.

The Company and BMS reported in October 2005 that the FDA issued an approvable letter for *Pargluva*, BMS's investigational oral medicine for the treatment of type 2 diabetes, and requested additional safety information to address more fully the cardiovascular safety profile of *Pargluva*. This data requirement may cause a significant delay in the product's launch. As a result, BMS and Merck terminated the collaborative agreement for *Pargluva*, with all rights to *Pargluva* and a back-up compound to *Pargluva* returning to BMS as of December 21, 2005.

The following chart reflects the Company's current research pipeline as of February 15, 2006. Candidates shown in Phase III include specific products. Candidates shown in Phase I and II include the most advanced compound with a specific mechanism in a given therapeutic area. Back-up compounds, regardless of their phase of development, additional indications in the same therapeutic area and additional line extensions or formulations for in-line products are not shown. The Company's programs are generally designed to focus on the development of novel medicines to address large, unmet medical needs. As announced in December 2005, the Company intends to focus its research efforts primarily on the following nine priority areas: Alzheimer's disease; atherosclerosis; cardiovascular disease; diabetes; novel vaccines; obesity; oncology; pain; and sleep disorders.

Research Pipeline

Phase I

Alzheimer's Disease	MK-0752, MK-0952
Arthritis	MK-0822
Atherosclerosis	MK-0354*, MK-0633, MK-0859
Cancer	MK-0429, MK-0752, Agensys*, MK-0731, VX-680*, MK-0646*
Cancer Vaccine	
Cardiovascular Disease	MK-0448
Diabetes	MK-0941, MK-0893, MK-0533
Endocrine	MK-0974
Flu Vaccine	
Glaucoma	MK-0994
Insomnia	MK-0454
Obesity	Nastech PYY3-36***
Osteoporosis	MK-0773
Pain	Neurogen*
Parkinson's Disease	MK-0657
Psychiatric Disease	MK-0249
Respiratory Disease	MK-0633
<i>S. aureus</i> Vaccine	

Phase II

Arthritis	MK-0686
Cancer (CTCL)	Vorinostat*
Endocrine	MK-0677
HIV Vaccine	
HPV Vaccine**	
Hypertension	MK-0736
Obesity	MK-0364, MK-0493
Osteoporosis	MK-0822
Pain	MK-0686, MK-0759, MK-0974
Pediatric Vaccine*	
Psychiatric Disease	MK-0364, Lurasidone*
Stroke	ONO 2506***
Urinary Incontinence	MK-0634, MK-0594

Phase III

AIDS	MK-0518
Atherosclerosis	MK-0524B, MK-0524A
CINV	MK-0517
Diabetes	MK-0431A
Insomnia	Gaboxadol*

Under Regulatory Review

HPV and Related Cervical Cancer and Genital Warts	<i>Gardasil**</i>
Shingles	<i>Zostavax</i>
Diabetes	<i>Januvia</i>

Approvable

Arthritis/Pain	<i>Arcoxia</i>
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2005 U.S. Approvals

Osteoporosis	<i>Fosamax Plus D</i>
Pediatric Vaccine	<i>ProQuad</i>

2006 U.S. Approvals

Rotavirus Gastroenteritis	<i>RotaTeq</i>
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* Licensed, alliance or acquisition (pipeline)

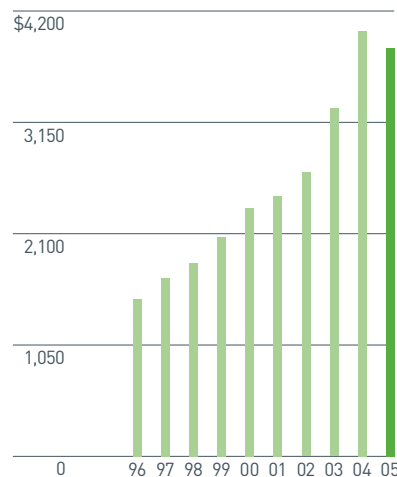
** Multiple licenses, including CSL, Ltd.

*** Merck is in discussions with its licensing partner regarding further plans for this compound.

Research and development expenses increased 22% in 2004. Included in the increase is a 2% unfavorable effect from inflation, a 2% unfavorable effect from exchange, and an 18% increase in volume, which reflects the Company's ongoing commitment to both basic and clinical research, as well as the impact of the licensing agreements and acquired research and development discussed above.

Research and development in the pharmaceutical industry is inherently a long-term process. The following data show a multi-year trend in the Company's research and development spending. For the period 1996 to 2005, the compounded annual growth rate in research and development was 11%.

Research and Development Expenditures \$ in millions



Restructuring Costs

Restructuring costs were \$322.2 million and \$107.6 million for 2005 and 2004, respectively. Included in 2005 are separation costs associated with Merck's plan to eliminate approximately 7,000 positions company-wide by the end of 2008. In the fourth quarter 2005, Merck incurred \$205.4 million in separation costs associated with this global restructuring program. The separation costs for 2005 are associated with the elimination of approximately 1,100 positions as of December 31, 2005 (which is comprised of actual headcount reductions, and the elimination of contractors and vacant positions), as well as estimates of future terminations of roughly 2,400 positions that were probable and could be reasonably estimated at December 31, 2005 (see Note 4).

As part of the cost-reduction initiative announced in October 2003 and completed at the end of 2004, the Company eliminated 5,100 positions. The Company completed a similar program in 2005 with 900 positions being eliminated through December 31, 2005. As a result of these restructuring actions, the Company recorded restructuring costs of \$116.8 million for 2005 and \$107.6 million for 2004.

Equity Income from Affiliates

Equity income from affiliates reflects the performance of the Company's joint ventures and partnership returns from AZLP. In 2005, the increase in equity income from affiliates primarily reflects the successful performance of *Zetia* and *Vytorin* through the Merck/Schering-Plough partnership and higher partnership returns from AZLP relative to 2004. In 2004, the increase in equity income from affiliates reflected the successful performance of *Zetia* through the Merck/Schering-Plough partnership as well as higher partnership returns from AZLP.

Earnings

(\$ in millions except per share amounts)	2005	Change	2004	Change	2003
Income from continuing operations	\$4,631.3	-20%	\$5,813.4	-12%	\$6,589.6
As a % of sales	21.0%		25.3%		29.3%
Net income	4,631.3		5,813.4		6,830.9
As a % of average total assets	10.6%		14.0%		14.9%
Earnings per common share assuming dilution from continuing operations	\$2.10	-20%	\$2.61	-11%	\$2.92

Taxes on Income

The Company's effective income tax rate was 37.1% in 2005, 27.1% in 2004 and 27.2% in 2003. The higher tax rate in 2005 reflects a net tax charge primarily related to the Company's decision to repatriate \$15.9 billion of foreign earnings in accordance with the AJCA of 2004. As a result, the Company recorded an income tax charge of \$766.5 million in Taxes on income in 2005 related to this repatriation. This charge was partially offset by a \$100 million benefit associated with a decision to implement certain tax planning strategies. This net tax charge resulted in an increase of 9.1 percentage points to the effective tax rate for the year. A change in mix of domestic and foreign income also had an unfavorable impact on the income tax rate. Partially offsetting the increase in the tax rate is the tax impact of the restructuring costs. The lower tax rate in 2004 and 2003 resulted in a change in mix of domestic and foreign income, which in 2004 included the impact of the *Vioxx* withdrawal, and in 2003 included the impact of restructuring costs and the wholesaler distribution program.

Income from Continuing Operations

Income from continuing operations declined 20% in 2005 compared to a 12% decline in 2004. Income from continuing operations as a percentage of sales was 21.0% in 2005, 25.3% in 2004 and 29.3% in 2003. The decrease in the percentage of sales ratio as compared to 2004 reflects the unfavorable impact of the voluntary worldwide withdrawal of *Vioxx* in 2004, as well as the impact of the global restructuring charge recorded in 2005. The percentage of sales for 2003 includes the implementation of a new wholesaler distribution program. Net income as a percentage of average total assets was 10.6% in 2005, 14.0% in 2004 and 14.9% in 2003.

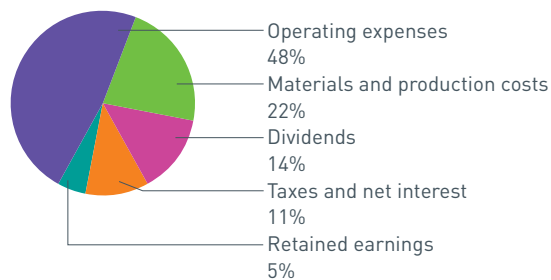
Other (Income) Expense, Net

The decrease in other (income) expense, net, in 2005 primarily reflects a \$176.8 million gain in 2004 from the sale of the Company's 50-percent equity stake in its European joint venture with Johnson & Johnson, as well as realized gains on the Company's investment portfolio recorded in 2004. These transactions were also the primary driver for the increase in other (income) expense, net, in 2004 over 2003.

Earnings per Common Share

Earnings per common share assuming dilution from continuing operations declined 20% in 2005 compared to a decline of 11% in 2004 reflecting the impact of the net tax charge and the restructuring costs recorded in 2005 and the unfavorable impact of the voluntary worldwide withdrawal of *Vioxx* in 2004.

Distribution of 2005 Sales and Equity Income



Selected Joint Venture and Affiliate Information

To expand its research base and realize synergies from combining capabilities, opportunities and assets, the Company has formed a number of joint ventures. (See Note 9 to the financial statements for further information.)

In 2000, the Company and Schering-Plough Corporation (Schering-Plough) entered into agreements to create separate equally-owned partnerships to develop and market in the United States new prescription medicines in the cholesterol-management and respiratory therapeutic areas. In 2001, the cholesterol-management partnership agreements were expanded to include all the countries of the world, excluding Japan. In 2002, ezetimibe, the first in a new class of cholesterol-lowering agents, was launched in the United States as *Zetia* (marketed as *Ezetrol* outside the United States). As reported by the Merck/Schering-Plough partnership, global sales of *Zetia* totaled \$1.4 billion in 2005, \$1.1 billion in 2004 and \$469.4

million in 2003. In July 2004, a combination product containing the active ingredients of both *Zetia* and *Zocor* was approved in the United States as *Vytorin* (marketed as *Inegy* outside the United States). *Vytorin* has been approved in over 47 countries outside the United States. Global sales of *Vytorin* were \$1.0 billion in 2005 and \$132.4 million in 2004. The results from the Company's interest in the Merck/Schering-Plough partnership are recorded in Equity income from affiliates. Merck recognized income of \$570.4 million in 2005, \$132.0 million in 2004 and a loss of \$92.5 million in 2003.

In 1982, the Company entered into an agreement with Astra AB (Astra) to develop and market Astra products in the United States. In 1994, the Company and Astra formed an equally-owned joint venture that developed and marketed most of Astra's new prescription medicines in the United States including *Prilosec*, the first in a class of medications known as proton pump inhibitors, which slows the production of acid from the cells of the stomach lining.

In 1998, the Company and Astra restructured the joint venture whereby the Company acquired Astra's interest in the joint venture, renamed KBI Inc. (KBI), and contributed KBI's operating assets to a new U.S. limited partnership named Astra Pharmaceuticals, L.P. (the Partnership), in which the Company maintains a limited partner interest. The Partnership, renamed AstraZeneca LP (AZLP), became the exclusive distributor of the products for which KBI retained rights.

Merck earns ongoing revenue based on sales of current and future KBI products and such revenue was \$1.7 billion, \$1.5 billion and \$1.9 billion in 2005, 2004 and 2003, respectively, primarily relating to sales of *Nexium* and *Prilosec*. In addition, Merck earns certain Partnership returns, which are recorded in Equity income from affiliates. Such returns include a priority return provided for in the Partnership Agreement, variable returns based, in part, upon sales of certain former Astra USA, Inc. products, and a preferential return representing Merck's share of undistributed AZLP GAAP earnings. These returns aggregated \$833.5 million, \$646.5 million and \$391.5 million in 2005, 2004 and 2003, respectively. The 2003 results reflect a lower preferential return, primarily resulting from the impact of generic competition for *Prilosec*.

In 1997, Merck and Rhône-Poulenc S.A. (now Sanofi-Aventis S.A.) combined their animal health and poultry genetics businesses to form Merial Limited (Merial), a fully integrated animal health company, which is a stand-alone joint venture, equally owned by each party. Merial provides a comprehensive range of pharmaceuticals and vaccines to enhance the health, well-being and performance of a wide range of animal species.

Sales of joint venture products were as follows:

(\$ in millions)	2005	2004	2003
Fipronil products	\$ 757.7	\$ 679.1	\$ 577.2
Avermectin products	467.5	452.4	476.7
Other products	761.8	704.3	634.9
	\$1,987.0	\$1,835.8	\$1,688.8

The poultry genetics business consisted of three segments. The domestic turkey and layer segments were divested in 2004 and 2003, respectively, and the broiler and foreign turkey

segments were sold in 2005. These transactions completed the divestiture of Merial's interest in the poultry genetics business. For comparative purposes the amounts presented above for 2005, 2004 and 2003, respectively, do not include revenue earned from the poultry genetics business.

In 1994, Merck and Pasteur Merieux Connaught (now Sanofi Pasteur S.A.) established a 50% owned joint venture to market vaccines in Europe and to collaborate in the development of combination vaccines for distribution in Europe. In September, Sanofi Pasteur MSD (SPMSD), Merck's vaccine joint venture with Sanofi Pasteur, entered into a Letter of Undertaking (LOU), with the European Medicines Agency due to Agency concerns regarding the long-term efficacy of the hepatitis B component of *Hexavac*. The hepatitis B component of *Hexavac* is manufactured by Merck. The LOU requires, in relevant part (1) suspension of the EU *Hexavac* license; (2) suspension of *Hexavac* distribution; (3) a recall of *Hexavac* product in the EU; (4) a recall of *Hexavac* in a number of non-EU countries; and (5) a surveillance program and possible future revaccination. SPMSD, which markets and sells *Hexavac* in part of the EU, has notified Merck that it is reserving any rights that it may have to seek damages from Merck and to be defended, indemnified and held harmless by Merck in the event of third party claims.

In September 2005, the European Medicines Agency (EMA) initiated a formal review of the long-term efficacy of the hepatitis B vaccine, *HBvaxPRO*, and of the hepatitis B component of the hepatitis B/Hib combination vaccine *Procomvax*. Both products are marketed and sold by SPMSD in its European territory, and are sold elsewhere, under different names, by Merck. An assessment report prepared for the EMA Committee for Medicinal Products for Human Use (CHMP) recommends limitations on the use of both products. This recommendation and Merck's response will be considered at a CHMP meeting in February 2006.

Sales of joint venture products were as follows:

(\$ in millions)	2005	2004	2003
Hepatitis vaccines	\$ 81.1	\$ 80.5	\$ 73.6
Viral vaccines	78.5	54.0	51.5
Other vaccines	705.5	672.5	543.9
	\$865.1	\$807.0	\$669.0

In 1989, Merck formed a joint venture with Johnson & Johnson to develop and market a broad range of nonprescription medicines for U.S. consumers. This 50% owned joint venture was expanded in Europe in 1993, and into Canada in 1996. In March 2004, Merck sold its 50% equity stake in its European joint venture to Johnson & Johnson for \$244.0 million and recorded a \$176.8 million gain as Other (income) expense, net. Merck will continue to benefit through royalties on certain products and also regained the rights to potential future products that switch from prescription to over-the-counter status in Europe.

Sales of joint venture products were as follows:

(\$ in millions)	2005	2004*	2003
Gastrointestinal products	\$250.8	\$269.2	\$299.6
Other products	2.5	46.1	146.2
	\$253.3	\$315.3	\$445.8

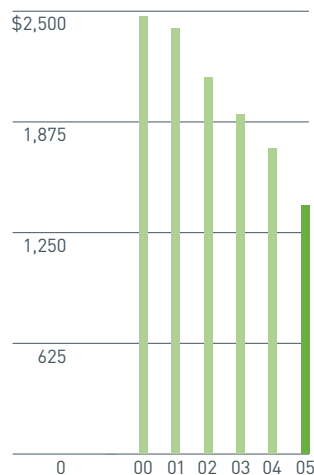
* Includes sales of the European joint venture up through March 2004.

Capital Expenditures

Capital expenditures were \$1.4 billion in 2005 and \$1.7 billion in 2004. Expenditures in the United States were \$938.7 million in 2005 and \$1.1 billion in 2004. Expenditures during 2005 included \$510.7 million for production facilities, \$476.8 million for research and development facilities, \$35.5 million for environmental projects, and \$379.7 million for administrative, safety and general site projects. Capital expenditures approved but not yet spent at December 31, 2005 were \$540.1 million. Capital expenditures for 2006 are estimated to be \$1.3 billion.

Depreciation was \$1.5 billion in 2005 and \$1.3 billion in 2004, of which \$1.1 billion and \$908.4 million, respectively, applied to locations in the United States. Total depreciation in 2005 includes accelerated depreciation of \$84.6 million associated with the global restructuring plan and \$103.1 million associated with the closure of the Terlings Park basic research center (see Note 4). The Company will incur significantly larger accumulated depreciation charges during 2006 as a result of these restructuring actions.

Capital Expenditures \$ in millions



Analysis of Liquidity and Capital Resources

Merck's strong financial profile enables the Company to fully fund research and development, focus on external alliances, support in-line products and maximize upcoming launches while providing significant cash returns to shareholders. Cash provided by operating activities of \$7.6 billion continues to be the Company's primary source of funds to finance capital expenditures, treasury stock purchases and dividends paid to stockholders. At December 31, 2005, the total of worldwide cash and investments was \$16.7 billion, including \$15.6 billion of cash, cash equivalents and short-term investments, and \$1.1 billion of long-term investments.

In October 2004, the AJCA was signed into law. The AJCA created temporary incentives through December 31, 2005 for U.S. multinationals to repatriate accumulated income earned outside of the United States as of December 31, 2002. In connection with the AJCA, the Company repatriated \$15.9 billion during 2005. As a result, the Company recorded an income tax charge of \$766.5 million in Taxes on Income in 2005 related to this repatriation, \$185 million of which was paid in 2005 and \$582 million of which will be paid in the first quarter of 2006. As of December 31, 2005, approximately \$5.2 billion of the AJCA repatriation was invested in fully collateralized overnight repurchase agreements and are included in Short-term investments in the Consolidated Balance Sheet. During the first quarter of 2006, the Company began reinvesting its repurchase agreement balances into other short- and long-term investments.

Selected Data

(\$ in millions)	2005	2004	2003
Working capital	\$7,745.8	\$1,731.1	\$1,957.6
Total debt to total liabilities and equity	18.1%	16.1%	16.7%
Cash provided by operations to total debt	0.9:1	1.3:1	1.2:1

To enable execution of the AJCA repatriation, the Company changed its mix of investments from long-term to short-term, resulting in a significant increase in working capital as of December 31, 2005. Working capital levels are more than adequate to meet the operating requirements of the Company. The ratios of total debt to total liabilities and equity and cash provided by operations to total debt reflect the strength of the Company's operating cash flows and the ability of the Company to cover its contractual obligations.

The Company's contractual obligations as of December 31, 2005 are as follows:

Payments Due by Period

(\$ in millions)	Total	2006	2007-2008	2009-2010	Thereafter
Purchase obligations	\$1,568.2	\$ 423.2	\$ 753.2	\$372.6	\$ 19.2
Loans payable and current portion of long-term debt	2,972.0	2,972.0	—	—	—
Long-term debt	5,125.6	—	1,739.6	311.9	3,074.1
Operating leases	266.3	79.8	94.3	45.9	46.3
	\$9,932.1	\$3,475.0	\$2,587.1	\$730.4	\$ 3,139.6

Purchase obligations consist primarily of goods and services that are enforceable and legally binding and include obligations for minimum inventory contracts, research and development and advertising. Research contracts do not include milestone payments contingent upon future events. Loans payable and current portion of long-term debt includes \$500 million of notes with a final maturity in 2011, which, on an annual basis, will either be repurchased from the holders at the option of the remarketing agent and remarketed, or redeemed by the Company. Loans payable and current portion of long-term debt also reflect \$337.5 million of long-dated notes that are subject to repayment at the option of the holders on an annual basis. Loans payable also includes \$1.6 billion of commercial paper issued by a foreign subsidiary under a \$3.0 billion commercial paper borrowing facility established in October 2005 to provide funding for a portion of the Company's AJCA repatriation. Required funding obligations for 2006 relating to the Company's pension and other postretirement benefit plans are not expected to be material.

In December 2004, the Company increased the capacity of its shelf registration statement filed with the Securities and Exchange Commission (SEC) to issue debt securities by an additional \$3.0 billion. In February 2005, the Company issued \$1.0 billion of 4.75% ten-year notes under the shelf. The remaining capacity under the Company's shelf registration statement is approximately \$2.8 billion.

In February 2005, the Company established a \$1.5 billion, 5-year revolving credit facility to provide backup liquidity for its commercial paper borrowing facility and for general corporate purposes. The Company has not drawn funding from this facility.

The Company's long-term credit ratings assigned by Moody's and Standard & Poor's are Aa3 and AA-, respectively. These ratings continue to allow access to the capital markets and flexibility in obtaining funds on competitive terms. The Company continues to maintain a conservative financial profile. Total cash and investments of \$16.7 billion exceeds the sum of loans payable and long-term debt of \$8.1 billion. The Company also has long-term credit ratings that remain among the top 4% of rated non-financial corporations. Despite this strong financial profile, certain contingent events, if realized, which are discussed in Note 11, could have a material adverse impact on the Company's liquidity and capital resources. The Company does not participate in any off-balance sheet arrangements involving unconsolidated subsidiaries that provide financing or potentially expose the Company to unrecorded financial obligations.

In July 2002, the Board of Directors approved purchases over time of up to \$10.0 billion of Merck shares. Total treasury stock purchased under this program in 2005 was \$1.0 billion. As of December 31, 2005, \$7.5 billion remains under the 2002 stock repurchase authorization approved by the Merck Board of Directors.

Financial Instruments Market Risk Disclosures

Foreign Currency Risk Management

While the U.S. dollar is the functional currency of the Company's foreign subsidiaries, a significant portion of the Company's revenues are denominated in foreign currencies. Merck relies on sustained cash flows generated from foreign sources to support its long-term commitment to U.S. dollar-based

research and development. To the extent the dollar value of cash flows is diminished as a result of a strengthening dollar, the Company's ability to fund research and other dollar-based strategic initiatives at a consistent level may be impaired. The Company has established revenue hedging and balance sheet risk management programs to protect against volatility of future foreign currency cash flows and changes in fair value caused by volatility in foreign exchange rates.

The objective of the revenue hedging program is to reduce the potential for longer-term unfavorable changes in foreign exchange to decrease the U.S. dollar value of future cash flows derived from foreign currency denominated sales, primarily the euro and Japanese yen. To achieve this objective, the Company will partially hedge anticipated third-party sales that are expected to occur over its planning cycle, typically no more than three years into the future. The Company will layer in hedges over time, increasing the portion of sales hedged as it gets closer to the expected date of the transaction, such that it is probable the hedged transaction will occur. The portion of sales hedged is based on assessments of cost-benefit profiles that consider natural offsetting exposures, revenue and exchange rate volatilities and correlations, and the cost of hedging instruments. The hedged anticipated sales are a specified component of a portfolio of similarly denominated foreign currency-based sales transactions, each of which responds to the hedged risk in the same manner. Merck manages its anticipated transaction exposure principally with purchased local currency put options, which provide the Company with a right, but not an obligation, to sell foreign currencies in the future at a predetermined price. If the U.S. dollar strengthens relative to the currency of the hedged anticipated sales, total changes in the options' cash flows fully offset the decline in the expected future U.S. dollar cash flows of the hedged foreign currency sales. Conversely, if the U.S. dollar weakens, the options' value reduces to zero, but the Company benefits from the increase in the value of the anticipated foreign currency cash flows. While a weaker U.S. dollar would result in a net benefit, the market value of the Company's hedges would have declined by \$113.0 million and \$45.2 million, respectively, from a uniform 10% weakening of the U.S. dollar at December 31, 2005 and 2004. The market value was determined using a foreign exchange option pricing model and holding all factors except exchange rates constant. Because Merck principally uses purchased local currency put options, a uniform weakening of the U.S. dollar will yield the largest overall potential loss in the market value of these options. The sensitivity measurement assumes that a change in one foreign currency relative to the U.S. dollar would not affect other foreign currencies relative to the U.S. dollar. Although not predictive in nature, the Company believes that a 10% threshold reflects reasonably possible near-term changes in Merck's major foreign currency exposures relative to the U.S. dollar. The cash flows from these contracts are reported as operating activities in the Consolidated Statement of Cash Flows.

The primary objective of the balance sheet risk management program is to protect the U.S. dollar value of foreign currency denominated net monetary assets from the effects of volatility in foreign exchange that might occur prior to their conversion to U.S. dollars. Merck principally utilizes forward exchange contracts, which enable the Company to buy and

sell foreign currencies in the future at fixed exchange rates and economically offset the consequences of changes in foreign exchange on the amount of U.S. dollar cash flows derived from the net assets. Merck routinely enters into contracts to fully offset the effects of exchange on exposures denominated in developed country currencies, primarily the euro and Japanese yen. For exposures in developing country currencies, the Company will enter into forward contracts on a more limited basis and only when it is deemed economical to do so based on a cost-benefit analysis that considers the magnitude of the exposure, the volatility of the exchange rate and the cost of the hedging instrument. The Company will also minimize the effect of exchange on monetary assets and liabilities by managing operating activities and net asset positions at the local level. The Company periodically uses forward contracts to hedge the changes in fair value of certain foreign currency denominated available-for-sale securities attributable to fluctuations in foreign currency exchange rates. A sensitivity analysis to changes in the value of the U.S. dollar on foreign currency denominated derivatives, investments and monetary assets and liabilities indicated that if the U.S. dollar uniformly weakened by 10% against all currency exposures of the Company at December 31, 2005, Income from continuing operations before taxes would have declined by \$3.5 million. Because Merck is in a net short position relative to its major foreign currencies after consideration of forward contracts, a uniform weakening of the U.S. dollar will yield the largest overall potential net loss in earnings due to exchange. At December 31, 2004, the Company was in a net long position relative to its major foreign currencies after consideration of forward contracts, therefore, a uniform 10% strengthening of the U.S. dollar would have reduced Income from continuing operations before taxes by \$7.8 million. This measurement assumes that a change in one foreign currency relative to the U.S. dollar would not affect other foreign currencies relative to the U.S. dollar. Although not predictive in nature, the Company believes that a 10% threshold reflects reasonably possible near-term changes in Merck's major foreign currency exposures relative to the U.S. dollar. The cash flows from these contracts are reported as operating activities in the Consolidated Statement of Cash Flows.

Interest Rate Risk Management

In addition to the revenue hedging and balance sheet risk management programs, the Company may use interest rate swap contracts on certain investing and borrowing transactions to manage its net exposure to interest rate changes and to reduce its overall cost of borrowing. The Company does not use leveraged swaps and, in general, does not leverage any of its investment activities that would put principal capital at risk. At December 31, 2005, the Company was a party to three pay-floating, receive-fixed interest rate swap contracts designated as fair value hedges of fixed-rate notes maturing in 2006, 2007 and 2013, respectively. The notional amounts of these swaps, which match the amount of the hedged fixed-rate notes, were \$500 million, \$350 million and \$500 million, respectively. The swaps effectively convert the fixed-rate obligations to floating-rate instruments. The cash flows from these contracts are reported as operating activities in the Consolidated Statement of Cash Flows.

The Company's investment portfolio includes cash equivalents and short-term investments, which at December 31, 2005 included repurchase agreements, the market values of which are not significantly impacted by changes in interest rates. The market value of the Company's medium- to long-term fixed-rate investments is modestly impacted by changes in U.S. interest rates. Changes in medium- to long-term U.S. interest rates have a more significant impact on the market value of the Company's fixed-rate borrowings, which generally have longer maturities. A sensitivity analysis to measure potential changes in the market value of the Company's investments, debt and related swap contracts from a change in interest rates indicated that a one percentage point increase in interest rates at December 31, 2005 and 2004 would have positively impacted the net aggregate market value of these instruments by \$236.2 million and \$75.4 million, respectively. A one percentage point decrease at December 31, 2005 and 2004 would have negatively impacted the net aggregate market value by \$283.6 million and \$115.4 million, respectively. The increased sensitivity is attributable to a change in the mix of investments from long-term fixed rate to short-term variable rate as of December 31, 2005. The fair value of the Company's debt was determined using pricing models reflecting one percentage point shifts in the appropriate yield curves. The fair value of the Company's investments was determined using a combination of pricing and duration models.

Critical Accounting Policies and Other Matters

The consolidated financial statements include certain amounts that are based on management's best estimates and judgments. Estimates are used in determining such items as provisions for sales discounts and returns, depreciable and amortizable lives, recoverability of inventories produced in preparation for product launches, amounts recorded for contingencies, environmental liabilities and other reserves, pension and other postretirement benefit plan assumptions, and taxes on income. Because of the uncertainty inherent in such estimates, actual results may differ from these estimates. Application of the following accounting policies result in accounting estimates having the potential for the most significant impact on the financial statements.

Revenue Recognition

Revenues from sales of products are recognized when title and risk of loss passes to the customer. Revenues for domestic pharmaceutical sales are recognized at the time of shipment, while for many foreign subsidiaries, as well as for shipping sales, revenues are recognized at the time of delivery. Recognition of revenue also requires reasonable assurance of collection of sales proceeds and completion of all performance obligations. Domestically, sales discounts are issued to customers as direct discounts at the point-of-sale or indirectly through an intermediary wholesale purchaser, known as chargebacks, or indirectly in the form of rebates. Additionally, sales are generally made with a limited right of return under certain conditions. Revenues are recorded net of provisions for sales discounts and returns, which are established at the time of sale.

The provision for aggregate indirect customer discounts covers chargebacks and rebates. Chargebacks are discounts that occur when a contracted customer purchases directly through an intermediary wholesale purchaser. The contracted customer generally purchases product at its contracted price plus a mark-up from the wholesaler. The wholesaler, in turn, charges the Company back for the difference between the price initially paid by the wholesaler and the contract price paid to the wholesaler by the customer. The provision for chargebacks is based on expected sell-through levels by the Company's wholesale customers to contracted customers, as well as estimated wholesaler inventory levels. Rebates are amounts owed based upon definitive contractual agreements or legal requirements with private sector and public sector (Medicaid) benefit providers, after the final dispensing of the product by a pharmacy to a benefit plan participant. The provision is based on expected payments, which are driven by patient usage and contract performance by the benefit provider customers.

The Medicare Prescription Drug Improvement and Modernization Act of 2003, commonly referred to as Medicare Part D, became effective January 1, 2006. The Company does not anticipate that Medicare Part D will have a material impact on its results of operations.

The Company assumes a first-in, first-out movement of inventory within the supply chain for purposes of estimating its aggregate indirect customer discount accrual. In addition, the Company uses historical customer segment mix, adjusted for other known events, in order to estimate the expected provision. Amounts accrued for aggregate indirect customer discounts are evaluated on a quarterly basis through comparison of information provided by the wholesalers and other customers to the amounts accrued. Adjustments are recorded when trends or significant events indicate that a change in the estimated provision is appropriate.

The Company continually monitors its provision for aggregate indirect customer discounts. There were no material adjustments to estimates associated with the aggregate indirect customer discount provision in 2005, 2004 and 2003.

Summarized information about changes in the aggregate indirect customer discount accrual is as follows:

	2005	2004
Balance, January 1	\$ 1,030.3	\$ 752.2
Current provision	4,419.1	4,031.6
Adjustments relating to prior years	134.7	57.7
Payments	(4,417.6)	(3,811.2)
Balance, December 31	\$ 1,166.5	\$ 1,030.3

Accruals for chargebacks are reflected as a direct reduction to accounts receivable and accruals for rebates as accrued expenses. The accrued balances relative to these provisions included in Accounts receivable and Accrued and other current liabilities were \$164.3 million and \$1.0 billion, respectively, at December 31, 2005, and \$133.7 million and \$896.6 million, respectively, at December 31, 2004.

The Company maintains a returns policy that allows its customers to return product within a specified period prior to

and subsequent to the expiration date (generally, six months before and twelve months after product expiration). The estimate of the provision for returns is based upon historical experience with actual returns. Additionally, the Company considers factors such as levels of inventory in the distribution channel, product dating and expiration period, whether products have been discontinued, entrance in the market of additional generic competition, changes in formularies or launch of over-the-counter products, to name a few. The product returns provision, as well as actual returns, were approximately 0.5% of net sales in 2005, 2004 and 2003.

Through the distribution program for U.S. wholesalers, implemented in 2003, the Company incentivizes wholesalers to align purchases with underlying demand and maintain inventories within specified levels. The terms of the program allow the wholesalers to earn fees upon providing visibility into their inventory levels as well as by achieving certain performance parameters, such as, inventory management, customer service levels, reducing shortage claims and reducing product returns. Information provided through the wholesaler distribution program includes items such as sales trends, inventory on-hand, on-order quantity and product returns.

Wholesalers generally provide only the above mentioned data to the Company, as there is no regulatory requirement to report lot level information to manufacturers, which is the level of information needed to determine the remaining shelf life and original sale date of inventory. Given current wholesaler inventory levels, which are generally less than a month, the Company believes that collection of order lot information across all wholesale customers would have limited use in estimating sales discounts and returns.

Inventories Produced in Preparation for Product Launches

The Company capitalizes inventories produced in preparation for product launches sufficient to support initial market demand. Typically, capitalization of such inventory does not begin until the related product candidates are in Phase III clinical trials and are considered to have a high probability of regulatory approval. At December 31, 2005, inventories produced in preparation for product launches consisted of three vaccine products, which are in Phase III clinical trials, a new formulation for an existing vaccine product, and a new compound for type 2 diabetes. The Company continues to monitor the status of each respective product within the regulatory approval process; however, the Company generally does not disclose specific timing for regulatory approval. If the Company is aware of any specific risks or contingencies other than the normal regulatory approval process or if there are any specific issues identified during the research process relating to safety, efficacy, manufacturing, marketing or labeling, the related inventory would generally not be capitalized. There are no significant issues with respect to any of these products. Expiry dates of the inventory are impacted by the stage of completion. The Company manages the levels of inventory at each stage to optimize the shelf life of the inventory in relation to anticipated market demand in order to avoid product expiry issues. The shelf lives for substantially all of these products range from a minimum of 8 to 13 years. Anticipated future sales of the

products support the realization of the inventory value as the inventory shelf life is sufficient to meet initial product launch requirements.

In addition, the Company produced inventory in preparation for the launch of *Arcoxia* in the United States. *Arcoxia* has been launched in 56 countries in Europe, Latin America, Asia and Africa. Additionally, the Company continues to work with regulatory agencies from other countries on registration materials to launch *Arcoxia* in those countries. In October 2004, the Company received an "approvable" letter from the FDA for the Company's NDA for *Arcoxia*. The FDA informed the Company in the letter that before approval of the NDA can be issued, additional safety and efficacy data for *Arcoxia* are required. Outside of the United States, Merck continues to work with local regulatory agencies to review and adjust prescribing information contained on *Arcoxia*'s label in those countries. While the minimum shelf life for *Arcoxia* is approximately 4 years, anticipated worldwide market demand in countries where *Arcoxia* has been approved supports the value of inventory capitalized. The build-up of inventory for *Arcoxia* and inventories produced in preparation for product launches did not have a material effect on the Company's liquidity.

Contingencies and Environmental Liabilities

The Company is involved in various claims and legal proceedings of a nature considered normal to its business, including product liability, intellectual property and commercial litigation, as well as additional matters such as antitrust actions. (See Note 11 to the financial statements for further information.) The Company records accruals for contingencies when it is probable that a liability has been incurred and the amount can be reasonably estimated. These accruals are adjusted periodically as assessments change or additional information becomes available. For product liability claims, a portion of the overall accrual is actuarially determined and considers such factors as past experience, number of claims reported and estimates of claims incurred but not yet reported. Individually significant contingent losses are accrued when probable and reasonably estimable.

Legal defense costs expected to be incurred in connection with a loss contingency are accrued when probable and reasonably estimable. As of December 31, 2004, the Company had established a reserve of \$675 million solely for its future legal defense costs related to the *Vioxx* Lawsuits and the *Vioxx* Investigations. During 2005, the Company spent \$285 million in the aggregate in legal defense costs worldwide related to (i) the *Vioxx* Product Liability Lawsuits, (ii) the *Vioxx* Shareholder Lawsuits, (iii) the *Vioxx* Foreign Lawsuits, and (iv) the *Vioxx* Investigations (collectively, the "*Vioxx* Litigation"). In the fourth quarter, the Company recorded a charge of \$295 million to increase the reserve solely for its future legal defense costs related to *Vioxx* to \$685 million at December 31, 2005. This reserve is based on certain assumptions and is the best estimate of the amount that the Company believes, at this time, it can reasonably estimate will be spent through 2007. Some of the significant factors considered in the establishment and ongoing review of the reserve for the *Vioxx* legal defense costs

were as follows: the actual costs incurred by the Company up to that time; the development of the Company's legal defense strategy and structure in light of the scope of the *Vioxx* Litigation; the number of cases being brought against the Company; the costs and outcomes of completed trials and the anticipated timing, progression, and related costs of pre-trial activities and trials in the *Vioxx* Product Liability Lawsuits. Events such as scheduled trials that are expected to occur throughout 2006 and into 2007, and the inherent inability to predict the ultimate outcomes of such trials, limit the Company's ability to reasonably estimate its legal costs beyond the end of 2007. The Company will continue to monitor its legal defense costs and review the adequacy of the associated reserves.

The Company currently anticipates that a number of *Vioxx* Product Liability Lawsuits will be tried in 2006. The Company cannot predict the timing of any trials with respect to the *Vioxx* Shareholder Lawsuits. The Company believes that it has meritorious defenses to the *Vioxx* Lawsuits and will vigorously defend against them. In view of the inherent difficulty of predicting the outcome of litigation, particularly where there are many claimants and the claimants seek indeterminate damages, the Company is unable to predict the outcome of these matters, and at this time cannot reasonably estimate the possible loss or range of loss with respect to the *Vioxx* Lawsuits. The Company has not established any reserves for any potential liability relating to the *Vioxx* Litigation.

The Company is a party to a number of proceedings brought under the Comprehensive Environmental Response, Compensation and Liability Act, commonly known as Superfund. When a legitimate claim for contribution is asserted, a liability is initially accrued based upon the estimated transaction costs to manage the site. Accruals are adjusted as feasibility studies and related cost assessments of remedial techniques are completed, and as the extent to which other potentially responsible parties (PRPs) who may be jointly and severally liable can be expected to contribute is determined.

The Company is also remediating environmental contamination resulting from past industrial activity at certain of its sites and takes an active role in identifying and providing for these costs. A worldwide survey was initially performed to assess all sites for potential contamination resulting from past industrial activities. Where assessment indicated that physical investigation was warranted, such investigation was performed, providing a better evaluation of the need for remedial action. Where such need was identified, remedial action was then initiated. Estimates of the extent of contamination at each site were initially made at the pre-investigation stage and liabilities for the potential cost of remediation were accrued at that time. As more definitive information became available during the course of investigations and/or remedial efforts at each site, estimates were refined and accruals were adjusted accordingly. These estimates and related accruals continue to be refined annually.

The Company believes that it is in compliance in all material respects with applicable environmental laws and regulations. Expenditures for remediation and environmental liabilities were \$31.3 million in 2005, and are estimated at \$53.5 million for the years 2006 through 2010. In management's opinion, the liabilities for all environmental matters that are probable and reasonably estimable have been accrued and totaled

\$100.4 million and \$127.5 million at December 31, 2005 and December 31, 2004, respectively. These liabilities are undiscounted, do not consider potential recoveries from insurers or other parties and will be paid out over the periods of remediation for the applicable sites, which are expected to occur primarily over the next 15 years. Although it is not possible to predict with certainty the outcome of these matters, or the ultimate costs of remediation, management does not believe that any reasonably possible expenditures that may be incurred in excess of the liabilities accrued should exceed \$88.0 million in the aggregate. Management also does not believe that these expenditures should result in a material adverse effect on the Company's financial position, results of operations, liquidity or capital resources for any year.

Pensions and Other Postretirement Benefit Plans

Net pension and other postretirement benefit cost totaled \$561.8 million in 2005 and \$521.5 million in 2004. Pension and other postretirement benefit plan information for financial reporting purposes is calculated using actuarial assumptions including a discount rate for plan benefit obligations and an expected rate of return on plan assets.

The Company reassesses its benefit plan assumptions on a regular basis. For both the pension and other postretirement benefit plans, the discount rate is evaluated annually and modified to reflect the prevailing market rate at December 31 of a portfolio of high-quality fixed-income debt instruments that would provide the future cash flows needed to pay the benefits included in the benefit obligation as they come due. At December 31, 2005, the Company changed its discount rate to 5.75% from 6.0% for its U.S. pension plan. The discount rate for the Company's U.S. other postretirement benefit plan remained the same at 5.75%.

The expected rate of return for both the pension and other postretirement benefit plans represents the average rate of return to be earned on plan assets over the period the benefits included in the benefit obligation are to be paid. In developing the expected rate of return, the Company considers long-term compound annualized returns of historical market data as well as actual returns on the Company's plan assets and applies adjustments that reflect more recent capital market experience. Using this reference information, the Company develops forward-looking return expectations for each asset category and a weighted average expected long-term rate of return for a targeted portfolio allocated across these investment categories. The expected portfolio performance reflects the contribution of active management as appropriate. As a result of this analysis, for 2006, the Company's expected rate of return of 8.75% remained unchanged from 2005 for its U.S. pension and other postretirement benefit plans.

The target investment portfolio of the Company's U.S. pension and other postretirement benefit plans is allocated 45% to 60% in U.S. equities, 20% to 30% in international equities, 15% to 25% in fixed-income investments and up to 8% in cash and other investments. The portfolio's equity weighting is consistent with the long-term nature of the plans' benefit obligation. The expected annual standard deviation of returns of the target

portfolio, which approximates 13%, reflects both the equity allocation and the diversification benefits among the asset classes in which the portfolio invests.

Actuarial assumptions are based upon management's best estimates and judgment. A reasonably possible change of plus (minus) 25 basis points in the discount rate assumption, with other assumptions held constant, would have an estimated \$40.8 million favorable (unfavorable) impact on net pension and postretirement benefit cost. A reasonably possible change of plus (minus) 25 basis points in the expected rate of return assumption, with other assumptions held constant, would have an estimated \$12.1 million favorable (unfavorable) impact on net pension and postretirement benefit cost. The Company does not expect to have a minimum pension funding requirement under the Internal Revenue Code during 2006. The preceding hypothetical changes in the discount rate and expected rate of return assumptions would not impact the Company's funding requirements.

Unrecognized net loss amounts reflect experience differentials primarily relating to differences between expected and actual returns on plan assets as well as the effects of changes in actuarial assumptions. Expected returns are based on a calculated market-related value of assets. Under this methodology, asset gains/losses resulting from actual returns that differ from the Company's expected returns are recognized in the market-related value of assets ratably over a five-year period. Total unrecognized net loss amounts in excess of certain thresholds are amortized into net pension and other postretirement benefit cost over the average remaining service life of employees. Amortization of total unrecognized net losses for the Company's U.S. plans at December 31, 2005 is expected to increase net pension and other postretirement benefit cost by approximately \$126.0 million annually from 2006 through 2010.

Taxes on Income

The Company's effective tax rate is based on pre-tax income, statutory tax rates and tax planning opportunities available in the various jurisdictions in which the Company operates. An estimated effective tax rate for a year is applied to the Company's quarterly operating results. In the event that there is a significant unusual or one-time item recognized, or expected to be recognized, in the Company's quarterly operating results, the tax attributable to that item would be separately calculated and recorded at the same time as the unusual or one-time item. The Company considers the resolution of prior year tax matters to be such items. Significant judgment is required in determining the Company's effective tax rate and in evaluating its tax positions. The Company establishes reserves when, despite its belief that the tax return positions are fully supportable, certain positions are likely to be challenged and that it may not succeed. [See Note 17 to the financial statements for further information.] The Company adjusts these reserves in light of changing facts and circumstances, such as the closing of a tax audit.

Tax regulations require items to be included in the tax return at different times than the items are reflected in the financial statements. As a result, the effective tax rate reflected in the financial statements is different than that reported in the

tax return. Some of these differences are permanent, such as expenses that are not deductible on the tax return, and some are timing differences, such as depreciation expense. Timing differences create deferred tax assets and liabilities. Deferred tax assets generally represent items that can be used as a tax deduction or credit in the tax return in future years for which the Company has already recorded the tax benefit in the financial statements. The Company establishes valuation allowances for its deferred tax assets when the amount of expected future taxable income is not likely to support the use of the deduction or credit. Deferred tax liabilities generally represent tax expense recognized in the financial statements for which payment has been deferred or expense for which the Company has already taken a deduction on the tax return, but has not yet recognized as expense in the financial statements.

As previously disclosed, in October 2004, the AJCA was signed into law. The AJCA creates a temporary incentive for U.S. multinationals to repatriate accumulated income earned outside of the United States as of December 31, 2002. In connection with the AJCA, the Company repatriated \$15.9 billion during 2005 (see Note 17). As a result of this repatriation, the Company recorded an income tax charge of \$766.5 million in Taxes on Income in 2005 related to this repatriation. This charge was partially offset by a \$100 million benefit associated with a decision to implement certain tax planning strategies. The Company has not changed its intention to indefinitely reinvest accumulated earnings earned subsequent to December 31, 2002. At December 31, 2005, foreign earnings of \$8.3 billion have been retained indefinitely by subsidiary companies for reinvestment. No provision will be made for income taxes that would be payable upon the distribution of such earnings and it is not practicable to determine the amount of the related unrecognized deferred income tax liability.

Recently Issued Accounting Standards

In November 2004, the FASB issued Statement No. 151, Inventory Costs—an amendment of ARB No. 43, Chapter 4 (FAS 151), which is effective beginning January 1, 2006. FAS 151 requires that abnormal amounts of idle facility expense, freight, handling costs and wasted material be recognized as current period charges. The Statement also requires that the allocation of fixed production overhead be based on the normal capacity of the production facilities. The effect of this Statement on the Company's financial position or results of operations is not expected to be material.

In December 2004, the FASB issued Statement No. 123R, Share-Based Payment (FAS 123R), which was originally intended to become effective beginning July 1, 2005. In April 2005, the Securities and Exchange Commission (SEC) issued a new rule which delayed the Company's effective date of FAS 123R beginning January 1, 2006. FAS 123R requires all share-based payments to employees to be expensed over the requisite service period based on the grant-date fair value of the awards and requires that the unvested portion of all outstanding awards upon adoption be recognized using the same fair value and attribution methodologies previously determined under Statement No. 123, Accounting for Stock-Based Compensation. On November 10, 2005 the FASB issued FASB Staff Position (FSP) 123R-3,

Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards, which provides an optional short cut method for calculating the historical pool of windfall benefits upon adoption of FAS 123R. The Company will adopt FAS 123R, and the FSP effective January 1, 2006. The Company will continue to use the Black-Scholes valuation method and will apply the modified prospective method. As a result of the adoption of this Statement, Merck's compensation expense for share-based payments is expected to be approximately \$220 million in 2006.

In November 2005, the FASB issued FSP 115-1 and FSP 124-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. The FSP addresses the determination as to when an investment is considered impaired, whether the impairment is other than temporary, and the measurement of an impairment loss as well as accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The FSP is effective beginning January 1, 2006. The effect of this Statement on the Company's financial position or results of operations is not expected to be material.

In December 2005, the SEC issued an Interpretation, *Commission Guidance Regarding Accounting for Sales of Vaccines and BioTerror Countermeasures to the Federal Government for Placement into the Pediatric Vaccine Stockpile or the Strategic National Stockpile*, which is effective beginning January 1, 2006. Under the Interpretation, the SEC will not object to revenue recognition from the sale of vaccines and bioterror countermeasures to the Federal government for placement into stockpiles related only to the Vaccines for Children Program or the Strategic National Stockpile. The effect of adoption of this Interpretation on the Company's financial position or results of operations is not expected to be material.

Cautionary Factors That May Affect Future Results

This annual report and other written reports and oral statements made from time to time by the Company may contain so-called "forward-looking statements," all of which are based on management's current expectations and are subject to risks and uncertainties which may cause results to differ materially from those set forth in the statements. One can identify these forward-looking statements by their use of words such as "expects," "plans," "will," "estimates," "forecasts," "projects" and other words of similar meaning. One can also identify them by the fact that they do not relate strictly to historical or current facts. These statements are likely to address the Company's growth strategy, financial results, product development, product approvals, product potential and development programs. One must carefully consider any such statement and should understand that many factors could cause actual results to differ materially from the Company's forward-looking statements. These factors include inaccurate assumptions and a broad variety of other risks and uncertainties, including some that are known and some that are not. No forward-looking statement can be guaranteed and actual future results may vary materially.

The Company does not assume the obligation to update any forward-looking statement. One should carefully evaluate such statements in light of factors, including risk factors, described in the Company's filings with the Securities and Exchange Commission, especially on Forms 10-K, 10-Q and 8-K. In Item 1 of the Company's annual report on Form 10-K for the year ended December 31, 2005, which will be filed in March 2006, the Company discusses in more detail various important factors that could cause actual results to differ from expected or historic results. The Company notes these factors for investors as permitted by the Private Securities Litigation Reform Act of 1995. Prior to the filing of the Form 10-K for the year ended December 31, 2005, reference should be made to Item 1 of the Company's annual report on Form 10-K for the year ended December 31, 2004. One should understand that it is not possible to predict or identify all such factors. Consequently, the reader should not consider any such list to be a complete statement of all potential risks or uncertainties.

Cash Dividends Paid per Common Share

	Year	4th Q	3rd Q	2nd Q	1st Q
2005	\$1.52	\$.38	\$.38	\$.38	\$.38
2004	\$ 1.49	\$.38	\$.37	\$.37	\$.37

Common Stock Market Prices

	4th Q	3rd Q	2nd Q	1st Q
2005				
High	\$32.54	\$32.34	\$35.20	\$32.61
Low	25.50	26.97	30.40	27.48
2004				
High	\$ 34.32	\$ 47.73	\$ 48.78	\$ 49.33
Low	25.60	32.46	44.28	42.85

The principal market for trading of the common stock is the New York Stock Exchange (NYSE) under the symbol MRK. The common stock market price information above is based on historical NYSE market prices.

Condensed Interim Financial Data⁽¹⁾

(\$ in millions except per share amounts)

	4th Q ⁽²⁾	3rd Q ⁽²⁾	2nd Q ⁽²⁾	1st Q
2005				
Sales	\$5,765.9	\$5,416.2	\$5,467.5	\$5,362.2
Materials and production costs	1,478.8	1,238.8	1,160.6	1,271.4
Marketing and administrative expenses	2,139.1	1,661.4	1,749.5	1,605.5
Research and development expenses	1,112.0	942.6	946.8	846.6
Restructuring costs	228.9	79.8	5.8	7.8
Equity income from affiliates	(586.6)	(480.1)	(334.1)	(316.3)
Other (income) expense, net	(126.3)	(24.7)	14.0	26.5
Income from continuing operations before taxes	1,520.0	1,998.4	1,924.9	1,920.7
Net income	1,119.7	1,420.9	720.6	1,370.1
Basic earnings per common share	\$.51	\$.65	\$.33	\$.62
Earnings per common share assuming dilution	\$.51	\$.65	\$.33	\$.62
2004				
Sales	\$ 5,748.0	\$ 5,538.1	\$ 6,021.7	\$ 5,630.8
Materials and production costs	1,283.6	1,364.2	1,163.7	1,148.2
Marketing and administrative expenses	2,347.2	1,718.4	1,594.3	1,578.7
Research and development expenses	1,108.6	919.3	986.0	996.3
Restructuring costs	18.6	34.5	21.9	32.7
Equity income from affiliates	(285.9)	(307.1)	(220.5)	(194.7)
Other (income) expense, net	(103.9)	(4.2)	37.5	(273.3)
Income from continuing operations before taxes	1,379.8	1,813.0	2,438.8	2,342.9
Net income	1,101.1	1,325.6	1,768.1	1,618.6
Basic earnings per common share	\$.50	\$.60	\$.80	\$.73
Earnings per common share assuming dilution	\$.50	\$.60	\$.79	\$.73

⁽¹⁾ Prior period amounts have been reclassified to reflect separate line item presentation of Restructuring costs.

⁽²⁾ Amounts for 2005 include the impact of restructuring actions (see Note 4). Amounts for 2005 and 2004 include the impact of the reserve for Viiox legal defense costs (see Note 11).

⁽³⁾ Amounts for 2004 include the impact of the voluntary worldwide withdrawal of Viiox (see Note 3).

⁽⁴⁾ Amounts for 2005 include the impact of the net tax charge primarily associated with the AJCA repatriation (see Note 17).