Appendix B

ANNUAL REPORT ILLUSTRATING REVISED FORM 10-K FORMAT

ANNUAL REPORT ILLUSTRATING REVISED FORM 10-K FORMAT

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

(MARK ONE)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 1997

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

COMMISSION FILE NUMBER X-XXXX

HEALTHCO INC.

(Exact name of registrant as specified in its charter)

DELAWARE	XX-XXXXXX
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

123 East 2nd Street Boston, Massachusetts (Address of principal executive offices)	02110 (Zip Code)

(617) 555-4321

(Registrant's telephone number including area code)

SECURITIES REGISTERED PURSUANT TO SECTION 12(B) OF THE ACT:

TITLE OF EACH CLASS	NAME OF EACH EXCHANGE ON WHICH REGISTERED
Common Stock, $.05 par value	New York Stock Exchange
Preferred Stock Purchase Rights	New York Stock Exchange

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES [X] NO [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in the definitive proxy or information statement incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

The aggregate market value of the voting stock held by non-affiliates of the registrant computed by reference to the closing price at which the stock was sold as of February 27, 1998 was approximately $12.2 billion.

The number of shares outstanding of each of the registrant's classes of common stock as of February 27, 1998 was 42,563,435 shares of common stock, all of one class.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 1998 Annual Meeting of Shareholders	Parts I, III, and IV

TABLE OF CONTENTS

SECTION	PAGE
A. Our Business	1
B. Selected Financial Data	2
C. Risks and Uncertainties That May Affect Our Future Results	4
D. Management's Discussion and Analysis of Segment Operations and Liquidity and Capital Resources	14
E. Financial Statements	27
F. Corporate Wide Matters	62
G. Submission of Matters to a Vote of Security Holders	63
H. Executive Officers of the Company	64
I. Market for the Company's Common Equity and Related Stockholder Matters	65
J. Changes in and Disagreements with Accountants on Accounting and Financial Disclosures	65
K. Directors and Executive Officers of the Company	65
L. Executive Compensation	65
M. Security Ownership of Certain Beneficial Owners and Management	65
N. Certain Relationships and Related Transactions	66
O. Exhibits	66
P. Reports on Form 8-K	66
Q. Signatures	66

A. Our Business

Healthco Inc. (the Company, which may be referred to as we, us, or our) is a research-based, global health care company. We discover, develop, manufacture and sell innovative products that improve the quality of life for people around the world and help them enjoy longer, healthier and more productive lives. Our products are available in more than 100 countries.

We operate in three business segments:

Health care, which includes prescription pharmaceuticals, bone and joint devices; specialty medical instruments and implants; and products for treating heart diseases and other disorders;

Animal health, which includes antiparasitics, anti-infectives, anti-inflammatory medicines and vaccines for livestock, poultry and pets; and

Consumer health care, which includes a variety of over-the-counter medications and personal care products.

A discussion of our operations for the past year is set forth below in Section D, "Management's Discussion and Analysis of Segment Operations and Liquidity and Capital Resources." To gain a more complete understanding of the risks inherent in our business, please also read Section C, "Risks and Uncertainties that May Affect our Future Results."

* * * * *

Our home page on the Internet is at www.healthco.com. That site includes an electronic copy of this annual report. Because the electronic version of our annual report includes hyperlinks and the capability to search for key words or phrases, some find that version easier to use. The information contained in the electronic version is identical to this printed version.

B. Selected Financial Data

(millions, except per share data)	Year ended December 31				
	1997	1996	1995	1994	1993
Net sales	**$24,376**	22,612	20,042	15,954	14,324
Alliance revenue	**632**	—	—	—	—
Total revenues	**25,008**	22,612	20,042	15,954	14,324
Cost of sales	**4,548**	4,352	4,328	3,444	3,118
Selling, informational and administrative	**9,912**	8,732	7,710	6,368	6,012
Research and development	**3,856**	3,368	2,884	2,252	1,922
Divestitures, restructuring and unusual items[(1)]	**—**	—	—	—	1,482
Other (income)/deductions—net	**516**	552	522	230	120
Income from continuing operations before taxes and minority interests	**6,176**	5,608	4,598	3,660	1,670
Provision for taxes on income	**1,730**	1,738	1,476	1,098	376
Income from continuing operations before cumulative effect of accounting changes	**$ 4,426**	3,858	3,108	2,552	1,290
Discontinued operations—net	**—**	—	38	44	26
Cumulative effect of accounting changes	**—**	—	—	—	—
Net income	**$ 4,426**	3,858	3,146	2,596	1,316
Effective tax rate	**28.0%**	31.0%	32.1%	30.0%	22.5%
Depreciation	**$ 832**	722	642	550	482
Property, plant and equipment additions	**1,886**	1,548	1,392	1,344	1,268
Cash dividends paid	**1,762**	1,542	1,318	1,188	1,172
As of December 31					
Working capital	**$ 3,030**	1,656	1,930	1,924	2,580
Property, plant and equipment—net	**8,274**	7,700	6,946	6,146	5,266

Total assets	**30,672**	29,334	25,458	22,198	18,662
Long-term debt	**1,458**	1,374	1,666	1,208	1,142
Long-term capital[(2)]	**17,704**	15,888	13,104	10,358	9,330
Share holders' equity	**15,866**	13,908	11,012	8,648	7,732
Per common share data:					
Basic:					
Income from continuing operations before effect of accounting changes	**$ 3.52**	3.10	2.52	2.08	1.02
Net income	**$ 3.52**	3.10	2.56	2.12	1.04
Diluted:					
Income from continuing operations before effect of accounting changes	**$ 3.40**	3.00	2.46	2.06	1.00
Net income	**$ 3.40**	3.00	2.50	2.08	1.02
Market value (December 31)	**$ 74.56**	41.50	31.50	19.31	17.25
Cash dividends paid	**1.36**	1.20	1.04	.94	.84
Shareholders' equity	**12.60**	11.08	8.90	7.10	6.22
Weighted average shares used to calculate:					
Basic earnings per share amounts	**1,257**	1,248	1,229	1,223	1,262
Diluted earnings per share amounts	**1,303**	1,288	1,259	1,243	1,282
Number of employees (thousands)	**49**	47	44	40	40
Total revenues per employee (thousands)	**$ 508**	486	458	396	358

We sold our food science business in 1996 and have reported it as a discontinued operation.

We have restated all common share and per share data for the 1997 and 1995 stock splits.

(1) Divestitures, restructuring and unusual items—net include pre-tax charges of approximately $1,490 million and $112 million to cover worldwide restructuring programs, as well as unusual items and a gain of approximately $120 million realized on the sale of our remaining interest in Hydrex Technologies Inc.

(2) Defined as long-term debt, deferred taxes on income, minority interests and shareholders' equity.

C. Risks and Uncertainties That May Affect Our Future Results

The Securities and Exchange Commission (SEC) encourages companies to disclose forward-looking information so that investors can better understand a company's future prospects and make informed investment decisions. This annual report contains such forward-looking statements that set out anticipated results based on management's plans and assumptions. Words such as "anticipate," "estimate," "expects," "projects," "intends," "plans," "believes" and words and terms of similar substance used in connection with any discussion of future operating or financial performance identify these forward-looking statements.

We cannot guarantee that any forward-looking statement will be realized, although we believe we have been prudent in our plans and assumptions. Achievement of future results are subject to risks, uncertainties and inaccurate assumptions. Should known or unknown risks or uncertainties materialize, or should underlying assumptions prove inaccurate, actual results could vary materially from those anticipated, estimated or projected. Investors should bear this in mind as they consider forward-looking statements. We undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise.

Risks and uncertainties particularly apply with respect to product-related forward-looking statements. The outcome of the lengthy and complex process of identifying new compounds and developing new products is inherently uncertain. Prospective products can fail to receive regulatory approval. There are also many considerations that can affect marketing of pharmaceutical and medical technology products around the world. Regulatory delays; the inability to successfully complete clinical trials; claims and concerns about safety and efficacy; new discoveries; patents and products by competitors and related patent disputes; and claims about adverse side effects are a few of the factors that could adversely affect the realization of research and development and product-related forward-looking statements.

Research and Product Development

Innovation by our research and development operations is very important to the success of our businesses. Our goal is to discover, develop and bring to market innovative products that address major unmet health care needs. This goal has been supported by our substantial research and development investments. In 1998, we anticipate investing more than $2 billion on research and development.

We are planning for future growth of our research operations. Current construction at our three major international research centers will add approximately one million square feet of laboratory space. Other research facilities are also being added or expanded. We conduct research internally, and also through contracts with third parties, through collaborations with universities and biotechnology companies, and in cooperation with other

pharmaceutical and medical products firms. We also seek out innovative technologies developed by third parties to acquire or incorporate into our product lines through licensing or other arrangements.

In view of the limited period of patent protection, and to gain the marketing advantage of being first to market in a particular therapeutic category, we try to be efficient as well as careful in our new product development. We strive to minimize delays in handling new product candidates and look for opportunities, such as contracting studies to outside researchers, to move development forward efficiently.

We feel that our investments in research have been rewarded by the number of pharmaceutical compounds and new therapies we have in all stages of development. In recent years, our discovery scientists have delivered dozens of new chemical compounds to early evaluation drug development stages. While each new candidate is far from regulatory approval, and many compounds fail at every step of the process, new drug candidates are a foundation for future products.

Our competitors also devote substantial sums and resources to research and development. In addition, the consolidation that has occurred in our industry has created additional companies with substantial research and development resources. The competition fostered by the fruits of this research could result in erosion of sales and unanticipated product obsolescence.

Decisions about research studies made early in the development process of a drug candidate can have a substantial impact on the marketing strategy once the drug receives approval. More detailed studies may demonstrate additional benefits that can help in the marketing, but they consume time and resources and can delay submitting the drug candidate for initial approval. We try to plan clinical trials prudently, but there is no guarantee that a proper balance of speed and testing will be made in each case. The quality of our decisions in this area can affect our future results.

Difficulties or delays in product manufacturing or marketing including, but not limited to, the inability to build up production capacity commensurate with demand, or the failure to predict market demand for or gain market acceptance of approved products could affect future results.

Financial Risk Management

The overall objective of our financial risk management program is to seek a reduction in the potential negative earnings effects from changes in foreign exchange and interest rates arising in our core business activities. We manage these financial exposures through

operational means and by using various financial instruments. These practices may change in the future as economic conditions change. We do not use financial instruments for trading purposes.

Foreign Exchange Risk
A significant portion of our revenues and earnings are exposed to changes in foreign exchange rates. Where practical, we seek to relate expected local currency revenues with local currency costs and local currency assets with local currency liabilities.

Foreign exchange risk is also managed through the use of foreign currency forward contracts. These contracts are used to offset the potential negative earnings effects from short-term foreign currency assets and liabilities that arise during normal operations.

In addition, foreign currency put options are purchased to reduce a portion of the potential negative effects on earnings related to certain of our significant anticipated intercompany inventory purchases for periods up to two years. These purchased options hedge Japanese yen and continental European currencies versus the U.S. dollar.

Also, under certain market conditions, we protect against possible declines in the reported net assets of certain key international subsidiaries—namely, those in Japan and Switzerland. We do this through borrowing in foreign currencies.

Our financial instrument holdings at year-end were analyzed to determine their sensitivity to foreign exchange rate changes. The fair value of these instruments was determined as follows:

- forward exchange contracts and currency swaps—net present values
- purchased foreign currency options—foreign exchange option pricing model
- foreign receivables, payables, debt and loans—changes in exchange rates.

In our sensitivity analysis, we assumed that the change in one currency's rates relative to the U.S. dollar would not have an effect on other currencies' rates relative to the U.S. dollar. All other factors were held constant. If there were an adverse change in foreign exchange rates of 10%, the expected effect on net income related to our financial instruments would be immaterial. For additional details, see Note 5-D to our financial statements, Derivative Financial Instruments—Accounting Policies.

Interest Rate Risk
Our U.S. dollar interest-bearing investments, loans and borrowings are subject to interest rate risk. In addition, we are also subject to interest rate risk on Japanese yen and Swiss franc short-term borrowings.

We invest and borrow primarily on a short-term or variable-rate basis. Under certain market conditions, interest rate swap contracts are used to adjust interest rate sensitive assets and liabilities.

Our financial instrument holdings at year-end were analyzed to determine their sensitivity to interest rate changes. The fair values of these instruments were determined by net present values. In our sensitivity analysis, we used the same change in interest rate for all maturities. All other factors were held constant. If interest rates increased by 10%, the expected effect on net income related to our financial instruments would be immaterial.

International Operations and Foreign Markets

We have significant operations outside the United States. They are conducted both through our subsidiaries and through distributors, and generally involve the same three business segments as our U.S. operations. Almost half of our revenues arise from international operations and revenue and net income growth in 1998 is expected to be impacted by changes in foreign exchange rates.

Revenues from Asia comprised approximately 13% of total revenues in 1997, including 9% from Japan. Revenues from the Asian markets most impacted by recent economic events—Korea, Indonesia, Thailand, Malaysia, Philippines and Taiwan—comprised approximately 2% of 1997 total revenues.

A new European currency is planned for introduction in January 1999 to replace the separate currency of several individual countries. This will entail changes in our operations as we modify systems and commercial arrangements to deal with the new currency. Modifications will be necessary in operations such as payroll, benefits and pension systems, contracts with suppliers and customers and internal financial reporting systems. Although a three-year transition period is expected during which transactions can be made in the old currencies, this may require dual currency processes for our operations. We have identified issues involved and are developing and implementing solutions. The cost of this effort is not expected to have a material effect on our business or results of operations. There is no guarantee, however, that all problems will be foreseen and corrected, or that no material disruption of our business will occur.

International operations could be affected by changes in intellectual property legal protections and remedies, trade regulations, and procedures and actions affecting approval, production, pricing, reimbursement and marketing of products, as well as by unstable governments and legal systems, intergovernmental disputes and possible nationalization.

Japan is our second-largest single national market, accounting for over a billion dollars in revenues, almost 9% of our total. No other single country outside the U.S. had rev-

enues approaching 10% of our total. Our aggregate sales to European Community countries, however, were about 20% of our revenues.

Additional information may be found by referring to Note 21 of our consolidated financial statements, Segment Information and Geographic Data.

Our international businesses are subject, in varying degrees, to a number of risks inherent in carrying on business in other countries. These include:

- currency fluctuations
- capital and exchange control regulations
- expropriation and nationalization
- other restrictive government actions.

In 1997, currency devaluations relative to the U.S. dollar reduced our reported revenues in many countries. Depending on the nature of the change in value relative to the U.S. dollar, changes in foreign currency values can either improve or reduce the reported dollar value of our net assets and results of operations. We cannot predict with certainty future changes in foreign exchange rates or the effect they will have on us. We attempt to anticipate such changes, however, and we try to mitigate their effects. For further information, see Note 5-D to our consolidated financial statements, Derivative Financial Instruments, and related information about valuation and risks associated with such financial instruments in parts E and F of that same note. Notwithstanding our efforts to foresee and mitigate the effects of changes in fiscal circumstances such as these, we cannot predict with certainty all changes in currency and interest rates, inflation or other related factors affecting our businesses. These factors could affect future results.

Patents and Intellectual Property Rights

Our products are sold around the world under brand-name trademarks we consider in the aggregate to be of material importance. Trademark protection continues in some countries as long as the mark is used; in other countries, as long as it is registered. Registrations generally are for fixed, but renewable, terms.

We own or are licensed under a number of U.S. and foreign patents. These patents cover:

- pharmaceutical and medical technology products
- pharmaceutical formulations
- product manufacturing processes
- intermediate chemical compounds used in manufacturing.

In 1997, neither the amounts we paid for license rights, nor amounts we received in connection with licenses granted by us to third parties, were material to our operations as a whole.

Patents for individual products extend for varying periods according to the date of patent filing or grant and the legal term of patents in the various countries where patent protection is obtained. The actual protection afforded by a patent, which can vary from country to country, depends upon the type of patent, the scope of its coverage, and the availability of legal remedies in the country.

In the aggregate, our patent and related rights are of material importance to our businesses in the United States and most other countries. Based on current product sales, and considering the vigorous competition with products sold by others, there are no patent rights we consider significant in relation to our business as a whole.

We expect that the patents on some of our newest products and late-stage product candidates could become significant to our business as a whole in the future.

The expiration of a product patent normally results in the loss of marketing exclusivity for the covered product and, particularly in the U.S., can result in a dramatic reduction in sales of the pioneering product. In some cases, however, we can continue to obtain commercial benefits from:

- product manufacturing trade secrets
- patents on processes and intermediates for the economical manufacture of the active ingredients
- patents for special formulations of the product or delivery mechanisms
- adaptation of the active ingredient to over-the-counter products.

The effect of product patent expiration also depends upon:

- the nature of the market and the position of the product in it
- the growth of the market
- the complexities and economics of manufacture of the product
- the requirements of generic drug laws.

One of the main limitations on our operations in some other countries is the lack of effective intellectual property protection of our products. Under international agreements in recent years, protection of intellectual property rights has been improving somewhat internationally. Pursuant to the North American Free Trade Agreement, Mexico improved its patent law to provide patent protection to pharmaceutical products. The General Agreement on Tariffs and Trade requires participant countries to amend their intellectual prop-

erty laws to provide patent protection for pharmaceutical products by the end of a ten-year transition period. A number of countries are doing this. We have experienced significant growth in our businesses in some of those nations. Our continued and expanded business in those countries depends to a large degree on continuing that improvement.

Competition

Competition is intense in all of our businesses, and includes many large and small competitors. No single company competes with us in all of our businesses, however.

The principal means of competition vary among product categories and business groups. Technological innovations affecting:

- efficacy
- safety
- patients' ease of use
- cost effectiveness

are important to success in all of our businesses. Our businesses also focus on unmet medical needs and improving therapies. Our emphasis on innovation has led to our multi-billion dollar research and development investments over the past decade.

In the current environment of competitive pressures on profit margins, we continue efforts to control the growth of our expenses. Although research and development budgets have grown significantly, in other areas such as manufacturing, distribution and sales administration, we have kept our costs down by restructuring and consolidating facilities. These measures have brought us new efficiencies and reduced or contained our operating expenses.

Business combinations among our competitors could affect our competitive position in the pharmaceutical, medical technology, animal health and consumer health care businesses. Similarly, combinations among our major customers could increase their purchasing power in dealing with us. And, of course, if we ourselves should enter into one or more business combinations, our business, finances and capital structure could be affected.

Government Regulation and Price Constraints

The FDA regulates our consumer health care business and, along with the U.S. Department of Agriculture and the Environmental Protection Agency, animal health products. These agencies enjoy significant discretionary powers to monitor our manufacturing and marketing activities in the United States.

Litigation
We are also subject to the jurisdiction of various other regulatory and enforcement departments and agencies, such as the Federal Trade Commission and the Department of Justice in the U.S., and are, therefore, subject to possible administrative and legal proceedings and actions by those organizations. Such actions may include product recalls, seizures and other civil and criminal sanctions. In some cases, we have initiated product recalls voluntarily. It is difficult to predict the future impact of the broad and expanding legislative and regulatory requirements affecting us.

Tax Legislation
Pursuant to the Small Jobs Protection Act of 1996 (the Act), Section 936 of the Internal Revenue Code (the U.S. possessions corporation income tax credit) was repealed for tax years beginning after December 31, 1995. The Act allows us to continue using the credit against the tax arising from manufacturing income earned in a U.S. possession for an additional ten-year period. The amount of manufacturing income eligible for the credit during this additional period is subject to a cap based on income earned prior to 1996 in the U.S. possession. This ten-year extension period does not apply to investment income earned in a U.S. possession, the credit on which expired as of July 1, 1996. The Act does not affect the amendments made to Section 936 by the 1993 Omnibus Budget Reconciliation Act, which provided for a five-year phase-down of the U.S. possession tax credit from 100% to 40%. In addition, the 1996 Act extended the R&D tax credit for 11 months effective July 1, 1996. In 1997, this credit was extended to June 30, 1998.

Environmental Law Compliance
Most of our manufacturing and certain research operations are affected by federal, state and local environmental laws. These laws relate to the discharge of materials or otherwise to the protection of the environment. We have made, and intend to continue to make, necessary expenditures for compliance with applicable laws. We are also cleaning up environmental contamination from past industrial activity at certain sites. As a result, we incurred capital and operational expenditures in 1997 for environmental protection and clean-up of certain past industrial activity as follows:

- environmental-related capital expenditures, $110 million;
- other environmental-related expenses, $134 million.

While we cannot predict with certainty the future costs of such clean up activities, capital expenditures, or operating costs for environmental compliance, we do not believe they will have a material effect on our capital expenditures, earnings or competitive position.

Expansion of Operations

Balancing current growth and investment to fuel future growth remains a major challenge. Our ongoing investments in new product introductions and research and development for future products could exceed corresponding sales growth. This could produce higher costs without a proportional increase in revenues.

Growth in costs and expenses, changes in product mix and the impact of divestitures, restructuring and other unusual items that could result from evolving business strategies, evaluation of asset realization, and organizational restructuring could affect future results. For example, we may be unable to continue or maintain margin improvements achieved in recent years, which would affect future results.

Raw Materials

Raw materials essential to our businesses are purchased worldwide in the ordinary course of business from numerous suppliers. In general, these materials are widely available from multiple sources. No serious shortages or delays were encountered in 1997, and none are expected in 1998.

Year 2000 Computer Systems Compliance

Many older computer software programs refer to years in terms of their final two digits only. Such programs may interpret the year 2000 to mean the year 1900 instead. If not corrected, those programs could cause date-related transaction failures.

We developed a Compliance Assurance Process to address this problem. A project team has performed a detailed assessment of all internal computer systems and is developing and implementing plans to correct the problems. Year 2000 problems affect many of our research and development, production, distribution, financial, administrative and communication operations. Systems critical to our business which have been identified as non-Year 2000 compliant are either being replaced or corrected through programming modifications. In addition, a separate team is looking at Year 2000 readiness from other aspects of our business, including customer order-taking, manufacturing, raw materials supply and plant process equipment. Outside companies such as vendors, major customers, service suppliers, communications providers and banks are being asked to verify their Year 2000 readiness and we are testing such systems where appropriate. We expect these projects to be successfully completed during 1999.

External and internal costs specifically associated with modifying internal use software for Year 2000 compliance are expensed as incurred. To this point, those costs have not been material. Costs to be incurred over the next two years to fix Year 2000 problems are estimated at approximately $40 million. Such costs do not include normal system upgrades and replacements. Based on our current plans and efforts to date, we expect that there will be no material harm to our operations.

Recently Issued Accounting Standards

In June 1997, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 130, *Reporting Comprehensive Income,* and SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information,* which become effective for our 1998 financial statements. SFAS No. 130 requires disclosure of comprehensive income, which consists of all changes in equity from nonshareholder sources. SFAS No. 131 requires that a company report information about its operating segments. The adoption of these statements will not impact our consolidated financial position, results of operations or cash flows, but will be limited to the form and content of our disclosures. Since most of the information required under these statements is currently disclosed, we do not expect their adoption to materially change our current disclosures.

D. Management's Discussion and Analysis of Segment Operations and Liquidity and Capital Resources

Overview of Our Consolidated Operating Results

In 1997, total revenue grew 11% to $25,008 million and net income exceeded $4 billion for the first time in our history. Diluted earnings per share increased 13% to $3.40.

As a percentage of total revenues, cost of sales continued to decline in 1997. We balanced revenue growth with substantial investments in product support and R&D. The effective tax rate decreased from 31.0% in 1996 to 28.0% in 1997. Net income has increased steadily as a percentage of total revenues from 1995 through 1997.

Analysis of the Consolidated Statement of Income

(millions of dollars)	**1997**	1996	1995	% Change* **97/96**	% Change* 96/95
Net sales	**$24,376**	$22,612	$20,042	**8**	13
Alliance revenue	**$ 632**	$ —	$ —	**—**	—
Total revenues	**$25,008**	$22,612	$20,042	**11**	13
Cost of sales	**$ 4,548**	$ 4,352	$ 4,328	**5**	1
% of total revenues	**18.2%**	19.2%	21.6%		
Selling, informational and administrative expenses	**$ 9,912**	$ 8,732	$ 7,710	**14**	13
% of total revenues	**39.6%**	38.6%	38.5%		
R&D expenses	**$ 3,856**	$ 3,368	$ 2,884	**14**	17
% of total revenues	**15.4%**	14.9%	14.4%		
Other deductions—net	**$ 516**	$ 552	$ 522	**(7)**	6
% of total revenues	**2.1%**	2.4%	2.6%		
Income before taxes	**$ 6,176**	$ 5,608	$ 4,598	**10**	22
% of total revenues	**24.7%**	24.8%	22.9%		
Taxes on income	**$ 1,730**	$ 1,738	$ 1,476	**(0)**	18
Effective tax rate	**28.0%**	31.0%	32.1%		
Income from continuing operations	**$ 4,426**	$ 3,858	$ 3,108	**15**	24
% of total revenues	**17.7%**	17.1%	15.5%		
Net income	**$ 4,426**	$ 3,858	$ 3,146	**15**	23
% of total revenues	**17.7%**	17.1%	15.7%		

**Percentages may reflect rounding adjustments*

Total Revenues

Total revenues increased $2,396 million in 1997 and $2,570 million in 1996. Excluding the impact of foreign exchange, total revenues grew by 14% in 1997 and 15% in 1996. These increases were primarily due to higher sales volume of our products in both years and revenue generated from business alliances (alliance revenue) in 1997.

Revenues were in excess of $20 million in each of 44 countries outside the U.S. in 1997, however the U.S. was the only country to contribute more than 10% to total revenues.

Costs and Expenses

Cost of sales increased 5% in 1997 as compared with 1% in 1996. As a percentage of total revenues, cost of sales declined in both 1997 and 1996 and largely reflects the following factors:

- a more favorable business and product mix
- productivity improvements
- effective foreign exchange hedging programs.

Selling, informational and administrative expenses increased 13% in both 1997 and 1996. These increases reflect a substantial global investment in our pharmaceutical selling efforts. These efforts included the creation of a new U.S. primary-care sales force, as well as the expansion of the U.S. specialist sales forces and sales forces in key international markets.

These expenses reflect costs of communicating scientific, medical and clinical information about our various products to the medical community and others. Health care information is communicated by field representatives, by means of medical symposia and conventions, as well as through distribution of product literature.

R&D expenses increased 14% in 1997 and 17% in 1996. These expenditures were necessary to support the advancement of potential drug candidates in all stages of development (from initial discovery through final regulatory approval). Health care R&D expenses, as a percentage of health care revenues, averaged 16% over the last three years.

Our **effective tax rate** decreased from 31.0% in 1996 to 28.0% in 1997. This decrease was mainly due to the favorable changes in the mix of income by country, partially offset by the continuing reduction of tax benefits from our operations in Puerto Rico as a result of the enactment of the Omnibus Budget Reconciliation Act of 1993 and the elimination of the tax exemption on Puerto Rican investment income.

We have received and are protesting assessments from the Belgian tax authorities. For additional details, see Note 8 to our financial statements, Taxes on Income.

Segment Operations

Animal Health Group

Percentage Change in Segment Profits

(millions of dollars)	**1997**	1996	1995	% Change **97/96**	% Change 96/95
Sales	**$2,658**	$2,444	$2,438	**+9**	—
Segment Profit	**$ 224**	$ 202	$ 194	**+11**	+4

Our Animal Health Group (AHG) discovers, develops, manufactures and sells animal health products for the prevention and treatment of diseases in livestock, poultry and pets. We are a significant manufacturer of antibiotics, antiparasitics, vaccines and related products for livestock and pets. Just as the success of Healthco's human pharmaceutical business has been achieved through strong, focused investment in innovative medicines that meet previously unmet medical needs, AHG is following a similar research-based, customer-driven approach as it strives to be the driving force in the worldwide animal health industry.

Healthco's animal health business is not only one of the largest in the world but is also noteworthy for the breadth of its product lines and its geographic coverage. Healthco offers leading antiparasitics, anti-infectives, anti-inflammatory medicines, and vaccines for both food animals and companion animals in all regions of the world.

Highly successful new product launches and additional claims for existing products generated strong growth for Healthco's AHG in 1997. In addition, in 1995, we acquired the Walker Industries Animal Health business, a leading producer of animal vaccines and pet products. That acquisition essentially doubled the revenues of our Animal Health Group, and complemented the products, target animal species and geographic sales coverage of our previous business.

Percentage Change in Total Revenues

	Total % Change	Analysis of Change: Volume	Analysis of Change: Price	Analysis of Change: Currency
1997 vs. 1996	**8.8**	**11.5**	**1.3**	**(4.0)**
1996 vs. 1995	0.2	2.5	(0.4)	(1.9)

Revenues

Highly successful new product launches were the principal driver of increased sales for AHG in 1997. In addition market conditions that had restrained growth in 1996 have improved. Animal health net sales were flat in 1996 due to adverse conditions in the U.S. and European livestock markets—including a depressed cattle market and high feed prices, heightened competition for companion animal products and the impact of unfavorable foreign exchange rate changes.

As noted above, our acquisition of Walker Industries' Animal Health business doubled the revenues of our Animal Health Group. This strategic acquisition also complemented the products, target animal species and geographic sales coverage of our previous business. In 1997 and 1996, Animal Health sales accounted for approximately 11% of our consolidated revenues, compared with 12% in 1995.

Animal health net sales grew 9% in 1997 led by several key products. Sales of companion animal products increased 14% and sales of products for food animals increased 7%. A more detailed discussion of the products offered by AHG and their impact on 1997 results of operations is set forth below.

Our leading Animal Health product in 1997 was Bovinex. Sales of Bovinex grew 58 percent in 1997 to $300 million. Bovinex is a scientifically differentiated, broad-spectrum parasiticide for the treatment and control of 36 stages of internal and external cattle parasites, including gastrointestinal roundworms, lungworms, eyeworms, grubs, lice, and mange mites. The product's long-acting efficacy is a key advantage, providing livestock producers with added convenience and reduced labor costs. In addition, Bovinex is well tolerated in injection-site tissue, an important consideration for maintaining meat quality. Already launched in an injectable form for cattle in all major markets, as well as for sheep and swine in some markets, Bovinex has now been introduced in the United States, the United Kingdom, and Australia as a pour-on formulation that is applied to cattle transdermally. A broad international rollout is planned for 1998. Customers have overwhelmingly accepted the pour-on formulation in each market in which it has been introduced, with sales in 1997 running well ahead of the highly successful injectable form launched in the United States the preceding year. Development of additional formulations for use in sheep is advancing.

Phentor also achieved strong growth in 1997. Phentor, a leading antibacterial for poultry and swine, achieved 16% sales growth to $190 million. Phentor is a leading antibiotic for food animals, a market category with annual sales of more than $500 million. This product competes effectively by providing excellent feed efficiency and weight gain, mainly in chickens and swine.

In the first quarter, Canidor, a nonsteroidal, anti-inflammatory medicine for treating osteoarthritis in dogs, was launched. Its 1997 sales reached $92 million. The highly successful 1997 launch of Canidor in the United States expands AHG's broad product line for companion animals and positions AHG as a leader in pain management and canine geriatric care. Canidor was quickly accepted by veterinarians and dog owners as the leading treatment for canine osteoarthritis, a progressive, degenerative affliction characterized by pain, joint swelling, and restricted activity. Osteoarthritis is found in approximately 20 percent of the canine population, or about 8 million dogs, in the United States. In the United States, more than a million dogs have already been treated with Canidor. A nonsteroidal anti-inflammatory drug, it inhibits the production of prostaglandins and thereby provides relief as both an anti-inflammatory and an analgesic. Canidor provides excellent relief of both acute and chronic pain and allows for repeated long-term treatment without many of the adverse side effects associated with other anti-inflammatory agents. Canidor is now the sixth-largest-selling companion animal product in the United States, where it was the first Healthco prescription animal health product featured in direct-to-consumer television advertising.

We market several other products that also contribute to annual revenues, although to a lesser extent than those described above. The other principal products of our Animal Health Group are Terramax, an injectable version of the Terramycin broad-spectrum antibiotic used for various animal diseases; our Mobox and Monox products to treat internal parasites; Poultrex and Vironex anticoccidials to treat parasitic infection in poultry; Megaswine, an antibacterial for pigs; and Barnex, for treating respiratory and digestive system diseases in livestock and poultry. We also manufacture and sell an extensive line of cattle, swine and pet vaccines including Vaxinon, Porcinex and Petguard.

We have a significant presence in the animal health marketplace, but many other companies offer competitive products. Altogether, there are hundreds of producers of animal health products throughout the world. The principal methods of competition vary somewhat depending on the particular product. They include:

- product innovation
- service
- price
- quality
- effective promotion to veterinary professionals and consumers.

Costs and Expenses

Gross margin increased to 65.6% in 1997 from 61.7% in 1996. This change was attributable to higher margins from sales of Canidor, which was introduced in 1997, as well as higher margins on certain proprietary products, most notably Bovinex and Phentor, which are in the early stages of their product life cycle. These increases were offset by lower

margins on certain products for which patents expired in 1996 and 1997. As a consequence, certain competitors both in the United States and in Europe have introduced competing generic products with lower price points.

Selling, informational and administrative expenses increased 15% in 1997 and 11% in 1996. This increase reflects increased costs incurred with the launch of new products, principally Canidor.

Separate sales organizations are used by our Animal Health business to promote its products. Its advertising and promotion are generally targeted to health professionals, directly and through medical journals. Animal health and nutrition products are sold through veterinarians, drug wholesalers, distributors, retail outlets and directly to users, including feed manufacturers and animal producers. Where appropriate, these products are also marketed through print and television advertising.

Research and development expenses increased 22% in 1997 and 18% in 1996. These increases reflect our continuing effort to develop new drugs and vaccines for the international animal health market. We expect to continue to make substantial investments in our research and development activities for the next several years. We also believe that continued research and development is critical to maintaining our leadership position in this market.

Changes in Geographic Total Revenues

	% Change in Total Revenues			
	U.S.		**International**	
	97/96	96/95	**97/96**	96/95
Animal Health	**26**	(8)	**0**	(5)

Revenue increases from sales outside of the United States were largely driven by macroeconomic factors, particularly in the livestock market. Contributing to this increase was the introduction of Bovinex to foreign markets. We expect to continue to pursue sales opportunities for our new products in markets abroad, pending regulatory approval.

Consumer Health Group

Percentage Change in Segment Profits

(millions of dollars)	**1997**	1996	1995	% Change* **97/96**	% Change* 96/95
Sales	**$972**	$908	$786	**+7**	+16
Segment Profit	**$ 78**	$ 72	$ 72	**+8**	—

**Percentages may reflect rounding adjustments.*

Healthco's Consumer Health Care Group (CHC) is a worldwide marketer of leading over-the-counter (OTC) health care products. Our consumer health products are among the industry leaders in eye care, anti-itch medicines, analgesics, and sleep aids. Consumer Health Care is unique in the OTC drug business, as it markets six number one share brands.

Percentage Change in Total Revenues

	Total % Change	Analysis of Change: Volume	Analysis of Change: Price	Analysis of Change: Currency
1997 vs. 1996	**7.0**	**6.0**	**2.0**	**(1.0)**
1996 vs. 1995	15.4	14.8	5.3	(4.7)

Revenues

In each of the past three years, sales of the Consumer Health Group accounted for 4% of our overall revenues. Our Consumer Health Care business offers an opportunity to expand sales of some of our prescription medications by evolving them to OTC medications. For example, we have launched three prescription drugs for over-the-counter use—OccuDrop, an antihistamine eyedrop; Histox, an antihistamine for allergies, and Robinex, a one-pill treatment for vaginal yeast infections in the United Kingdom.

Consumer health care net sales increased 7% in 1997 and 15% in 1996. One factor contributing to these sales increases was the growth of the over-the-counter versions of previously prescription-only drugs, which were launched in 1996 and 1995. This segment's sales also benefited from the 1996 acquisition of the Dermasol and Licend brands and the 1995 acquisition of SunSkin. An analysis of those products that contributed to our increase in sales follows:

Topical Products

New products introductions and an aggressive new marketing campaign in Europe were the primary drivers of revenue growth for this line of products. Derminex continues to

be our most popular brand. Derminex's active ingredient, zinc oxide, promotes healing, protects, and helps seal out wetness that can cause diaper rash. Fast acting, the product can show significant improvement just 10 hours after application. The Derminex line was expanded at the end of 1997 with the launch of Derminex Creamy, a highly effective, lighter formulation. This new formulation has already captured 10 percent of the market and contributed $32 million, or 50% of the sales increase we enjoyed in 1997. Other producers in our topical products line include Dermasol hydrocortisone products, acquired by CHC in 1996, which provides temporary relief of itching associated with minor skin irritations and rashes due to eczema, insect bites, poison ivy, dry skin, and other causes and Musclex, for relief from the pain and stiffness of minor arthritis and muscle aches since its introduction in 1898.

Sonom

Medical tests have shown that Sonom, with the active ingredient doxylamine succinate, helps people fall asleep faster and stay asleep longer. It provides the convenience of single-tablet dosing and is non-habit-forming. Sonom was marketed overseas on a trial basis in late 1987. As a result, sales increased over 30%. We anticipate offering Sonom in additional overseas markets in 1998.

Licend

Licend, CHC's pyrethrin-based medicine for killing head, body, and crab lice, showed strong sales growth in 1997. Sales of this brand have doubled in a four-year period due to increased consumer awareness brought about by our new media campaign.

Other Consumer Health Products

CHC's broad product offering also includes NoPlak pre-brushing dental rinse, Zamboni shaving creams and SunSkin sun care products, all competitive brands in the U.S. market.

Changes in Geographic Total Revenues

	% Change in Total Revenues			
	U.S.		International	
	97/96	96/95	**97/96**	96/95
Consumer Health Care	**6**	22	**9**	4

International Operations

Healthco's Mexican consumer products business is the market leader in shampoos and other hair care products, and has now successfully launched the OTC brands Occuson, Derminex, and Musclex. CHC also has growing businesses in the United Kingdom, Canada, and several Asian markets. We expect operations overseas to be a significant source of revenue growth in future periods.

New Product Development
Several product-line extensions building on these brands have been introduced in recent years. Other products are sold only in selected international markets. For example, an OTC formulation of Robinex known as Robinex One is sold in the U.K. as a treatment for vaginal candidiasis. Similarly, Histox is sold as an OTC product in Canada under the brand name Flurex. As market conditions permit, and when we have necessary approval from drug regulatory authorities, we plan to pursue similar launches for other products over time.

Heavy expenditures for advertising, promotion and marketing are generally required to achieve consumer acceptance of consumer health care products. As a consequence, the ratio of marketing expense to sales revenue is relatively higher for our Consumer Health business, as compared to both our Health Care and Animal Health segments. Our Consumer Health Care business around the world uses its own representatives to promote its products. This business uses substantial print and television consumer advertising for its brand-name products. Those products are sold through various retailers.

Many other companies, large and small, manufacture and sell one or more products that are similar to our consumer health care products. The principal methods of competition in the OTC market include:

- product quality
- advertising and promotion
- product innovation
- broad distribution capabilities
- customer satisfaction
- price.

Costs and Expenses
Gross margin remained unchanged from 1996 at 47% and decreased slightly from 49% in 1995. The lower gross margins in the consumer health market reflect the maturity of the market and a greater level of competition. We have been successful in offsetting margin decrease for certain, older products by developing and marketing new formulations of our existing product line. We are also alert to possibilities to acquire brands that we believe would contribute to the growth and profitability of this segment.

Selling, informational and administrative expenses increased 12% in 1997 and 11% in 1996. These cost increases can be attributed to the marketing campaigns associated with certain new products, most notably Derminex Creamy, and continuing efforts to

differentiate our consumer health products from others in the marketplace. We believe that the level of spending required to protect our brand leadership will continue in future periods.

Research and development expenses remained unchanged at 6% of revenues for both 1997 and 1996. Although the level of spending at CHC does not approach that of our Heath Care or Animal Health group, we believe that continuing research is essential to the success of this business segment.

Health Care Group

Disclosures related to the Health Care segment have been omitted in the interest of reducing the size of this document.

Financial Condition, Liquidity and Capital Resources

The net financial assets/(debt) position as of December 31 is as follows:

(millions of dollars)	**1997**	1996	1995
Financial assets*	**$6,088**	$6,308	$ 4,692
Short- and long-term debt	**5,968**	5,844	5,738
Net financial assets/(debt)	**$ 120**	$ 464	$(1,046)

**Consists of cash and cash equivalents, short-term investments and loans and long-term loans and investments.*

The net financial debt position at December 31, 1995 resulted primarily from higher debt levels following the Walker Industries' acquisition.

Selected Measures of Liquidity and Capital Resources

	1997	1996	1995
Cash and cash equivalents and short-term investments and loans (millions of dollars)	**$3,408**	$3,982	$3,602
Working capital (millions of dollars)	**3,030**	1,656	1,930
Current ratio	**1.29:1**	1.15:1	1.19:1
Shareholders' equity per common share*	**$12.60**	$11.08	$ 8.90
Debt to total capitalization**	**27%**	30%	34%

**Represents total shareholders' equity divided by the actual number of common shares outstanding.*
***Represents total short-term borrowings and long-term debt divided by the sum of total short-term borrowings, long-term debt and total shareholders' equity.*

The increase in working capital from 1996 to 1997 was primarily due to the following:

Increases in:

- *Accounts receivable*—due in part to the alliance revenue receivables
- *Inventory*—due to higher pharmaceutical inventory levels for new products
- *Prepaid expenses, taxes and other assets*—due to the reclassification of Diagnostix net assets to other assets.

Decreases in:

- *Short-term loans*—primarily due to the renewal of short-term loans to loans with maturities beyond one year
- *Income taxes payable*—primarily due to the settlements of tax-related contingencies.

Working capital decreased in 1996. We utilized working capital provided by operations, as well as the proceeds from the sale of the food science business and stock option transactions primarily for additions to property, plant and equipment, business acquisitions, payments of dividends and the net repayment of long-term debt. Additionally, the 6 1/2% notes due in 1997 were reclassified from Long-term debt to Short-term borrowings in 1996.

The increase in shareholders' equity per common share in 1997 and 1996, as well as the decrease in the 1997 and 1996 percentage of debt to total capitalization was primarily due to growth in net income.

Summary of Cash Flows

Operations in 1997 provided significant cash inflows. Commercial paper and short-term borrowings supplement operating cash flows.

(millions of dollars)	**1997**	1996	1995
Cash provided by/(used in):			
Operating activities	**$ 3,258**	$ 4,134	$ 3,642
Investing activities	**(2,044)**	(1,874)	(4,686)
Financing activities	**(1,696)**	(764)	(1,038)
Effect of exchange rate changes on cash and cash equivalents	**(64)**	(2)	(28)
Net increase/(decrease) in cash and cash equivalents	**$ (546)**	$ 1,494	$(2,110)

Cash flows from operating activities decreased in 1997 as the growth in net income was offset by an increase in accounts receivable and inventories.

Cash flows from operating activities increased in 1996 primarily due to growth in net income generated by the continued rollout of new pharmaceutical products and additional uses for existing products.

Net cash used in investing activities changed in 1997 largely due to the:

- increase in property, plant and equipment which, in part, reflects facility enhancements to our manufacturing locations
- decrease in proceeds from the sale of businesses
- absence of business acquisitions in 1997.

In 1998, additions to property, plant and equipment are expected to be similar to 1997 additions.

Net cash used in investing activities decreased in 1996 as compared to 1995 primarily due to a decrease in business acquisitions and an increase in proceeds from the sale of a business.

Net cash used in financing activities changed in 1997 largely due to:

- the increase in common stock repurchases at a higher average price
- higher dividend payments to our shareholders
- higher cash received from employee stock option exercises.

Net cash used in financing activities decreased in 1996 as compared to 1995 primarily due to higher levels of short-term borrowings to fund working capital needs, as well as certain investment opportunities, partially offset by net repayments of long-term debt.

In September 1996, we announced a program to purchase up to $2 billion of our common stock over the ensuing 18 to 24 months in the open market or in privately negotiated transactions. Under this program, approximately 11.4 million shares were repurchased in 1997 and .6 million shares in 1996. These shares were purchased in the open market at a cost of approximately $1,172 million in 1997 and $54 million in 1996. Purchased shares are available for general corporate purposes.

We have available lines of credit and revolving-credit agreements with a select group of banks and other financial intermediaries. Major unused lines of credit totaled approximately $2.6 billion at December 31, 1997.

Our short-term debt has been rated A1 by Moody's Investors Services (Moody's) and P1 by Standard and Poor's (S&P). Also, our long-term debt has been rated Aaa by Moody's and AAA by S&P for the past 12 years. Moody's and S&P are the major corporate debt-rating organizations and these are their highest ratings.

Dividend Growth
Cash dividends paid per common share divided by diluted earnings per common share amounted to 40.0% in 1997, 40.0% in 1996 and 41.6% in 1995. In January 1998, the Board of Directors declared a first-quarter 1998 dividend of $.19, an increase of 12% over the $.17 per share dividend declared in each quarter of 1997. This marked the 11th consecutive year of quarterly dividend increases.

E. Financial Statements

Management's Report
The financial statements that appear in this report were prepared by and are the responsibility of the Company's management. These financial statements are in conformity with generally accepted accounting principles and, therefore, include amounts based on informed judgments and estimates. Management also accepts responsibility for the preparation of other financial information included in this document.

The Company's management has designed a system of internal control to safeguard its assets, ensure that transactions are properly authorized and provide reasonable assurance, at reasonable cost, as to the integrity, objectivity and reliability of financial information. Even an effective internal control system, regardless of how well designed, has inherent limitations and, therefore, can provide only reasonable assurance with respect to financial statement preparation. The system is built on a business ethics policy that requires all employees to maintain the highest ethical standards in conducting Company affairs. The system of internal control includes careful selection, training and development of financial managers, an organizational structure that segregates responsibilities and a communications program which ensures that Company policies and procedures are well understood throughout the organization. The Company also has an extensive program of internal audits, with prompt follow-up, including reviews of separate Company operations and functions around the world.

The Company's independent certified public accountants, Bonds, Mays & Henderson LLP, have audited the annual financial statements in accordance with generally accepted auditing standards. The Independent Auditors' Report expresses an informed judgment as to the fair presentation of the Company's reported operating results, financial position and cash flows. This judgment is based on the results of auditing procedures performed and such other tests that they deemed necessary, including consideration of the Company's internal control structure.

Recommendations made by Bonds, Mays & Henderson LLP and the Company's internal auditors are considered and appropriate action taken with respect to these recommendations. The Company believes that its system of internal control is effective and adequate to accomplish the objectives discussed above.

Daniel R. Morrison, *Principal Executive Officer*
Michael E. Groves, *Principal Financial Officer*
Adam L. Shea, *Principal Accounting Officer*
February 26, 1998

Audit Committee's Report

The Board of Directors reviews the audit function, internal controls and financial statements largely through its Audit Committee, which consists solely of directors who are not Company employees. In 1997, the Audit Committee met six times with management, the independent auditors and internal auditors concerning their respective responsibilities. Among its various duties, the Audit Committee recommends the appointment of the Company's independent auditors. Both Bonds, Mays & Henderson LLP and the internal auditors have full access to the Audit Committee and meet with it, without management present, to discuss the scope and results of their examinations including internal control, audit and financial reporting matters.

David L. Kingsley, *Chair, Audit Committee*
February 26, 1998

Independent Auditors' Report

To the Shareholders and Board of Directors of Healthco Inc.:

We have audited the accompanying consolidated balance sheet of Healthco Inc. and subsidiary companies as of December 31, 1997, 1996 and 1995 and the related consolidated statements of income, shareholders' equity and cash flows for each of the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Healthco Inc. and subsidiary companies at December 31, 1997, 1996 and 1995, and the results of their operations and their cash flows for each of the years then ended, in conformity with generally accepted accounting principles.

Bonds, Mays & Henderson LLP

Boston, Massachusetts
February 26, 1998

Consolidated Statement of Income

	Year ended December 31		
(millions, except per share data)	**1997**	1996	1995
Net sales	**$24,376**	$22,612	$20,042
Alliance revenue	**632**	—	—
Total revenues	**25,008**	22,612	20,042
Costs and expenses			
Cost of sales	**4,548**	4,352	4,328
Selling, informational and administrative expenses	**9,912**	8,732	7,710
Research and development expenses	**3,856**	3,368	2,884
Other deductions—net	**516**	552	522
Income from continuing operations before provision for taxes on income and minority interests	**6,176**	5,608	4,598
Provision for taxes on income	**1,730**	1,738	1,476
Minority interests	**20**	12	14
Income from continuing operations	**4,426**	3,858	3,108
Discontinued operations—net of taxes on income	**—**	—	38
Net income	**$ 4,426**	$ 3,858	$ 3,146
Earnings per common share—basic			
Income from continuing operations	**$ 3.52**	$ 3.10	$ 2.52
Discontinued operations—net of taxes on income	**—**	—	.04
Net income	**$ 3.52**	$ 3.10	$ 2.56
Earnings per common share—diluted			
Income from continuing operations	**$ 3.40**	$ 3.00	$ 2.46
Discontinued operations—net of taxes on income	**—**	—	.04
Net income	**$ 3.40**	$ 3.00	$ 2.50
Weighted average shares—basic	**1,257**	1,248	1,229
Weighted average shares—diluted	**1,303**	1,288	1,259

See Notes to Consolidated Financial Statements which are an integral part of these statements.

Consolidated Balance Sheet

(millions, except per share data)	December 31 **1997**	1996	1995
Assets			
Current Assets			
Cash and cash equivalents	**$ 1,754**	$ 2,300	$ 806
Short-term investments	**1,424**	974	2,218
Accounts receivable, less allowance for doubtful accounts: 1997—$102; 1996—$116; 1995—$122	**5,054**	4,504	4,048
Short-term loans	**230**	708	578
Inventories			
Finished goods	**1,354**	1,234	1,128
Work in process	**1,704**	1,390	1,158
Raw materials and supplies	**488**	554	482
Total inventories	**3,546**	3,178	2,768
Prepaid expenses, taxes and other assets	**1,632**	1,272	1,886
Total current assets	**13,640**	12,936	12,304
Long-term loans and investments	**2,680**	2,326	1,090
Property, plant and equipment, less accumulated depreciation	**8,274**	7,700	6,946
Goodwill, less accumulated amortization: 1997—$304; 1996—$230; 1995—$158	**2,588**	2,848	2,486
Other assets, deferred taxes and deferred charges	**3,490**	3,524	2,632
Total assets	**$30,672**	$29,334	$25,458
Liabilities and Shareholders' Equity			
Current Liabilities			
Short-term borrowings, including current portion of long-term debt	**$ 4,510**	$ 4,470	$ 4,072
Accounts payable	**1,530**	1,826	1,430
Income taxes payable	**1,570**	1,784	1,644
Accrued compensation and related items	**954**	872	842
Other current liabilities	**2,046**	2,328	2,386
Total current liabilities	**10,610**	11,280	10,374
Long-term debt	**1,458**	1,374	1,666
Postretirement benefit obligation other than pension plan	**788**	824	852
Deferred taxes on income	**312**	506	332
Other noncurrent liabilities	**1,638**	1,442	1,222
Total liabilities	**14,806**	15,426	14,446
Shareholders' Equity			
Preferred stock, without par value; 12 shares authorized, none issued	**—**	—	—
Common stock, $.05 par value; 3,000 shares authorized; issued: 1997—1,388; 1996—1,378; 1995—1,371	**138**	138	138
Additional paid-in-capital	**6,478**	3,386	2,400
Retained earnings	**18,698**	16,034	13,718
Currency translation adjustment and other	**(170)**	290	326
Employee benefit trusts	**(5,292)**	(2,976)	(2,340)
Treasury stock, at cost: 1997—94; 1996—87; 1995—96	**(3,986)**	(2,964)	(3,230)
Total shareholders' equity	**15,866**	13,908	11,012
Total liabilities and shareholders' equity	**$30,672**	$29,334	$25,458

See Notes to Consolidated Financial Statements which are an integral part of these statements.

Consolidated Statement of Shareholders' Equity

(millions)	Common Stock		Additional Paid-In Capital	Retained Earnings	Currency Translation Adjustment and Other	Employee Benefit Trusts	Treasury Stock		Total
	Shares	Par Value					Shares	Cost	
Balance January 1, 1995, as reported	681	$ 68	$1,302	$11,890	$ 392	$(1,498)	(52)	$(3,506)	$ 8,648
Restatement for the 1997 stock split	680	70	(70)	—	—	—	(52)	—	—
Balance January 1, 1995, as restated	1,361	138	1,232	11,890	392	(1,498)	(104)	(3,506)	8,648
Net income				3,146					3,146
Cash dividends declared				(1,318)					(1,318)
Currency translation adjustment					24				24
Stock option transactions	9	—	252				8	158	410
Purchases of common stock							(10)	(216)	(216)
Employee benefit trust transactions—net			880			(842)			38
Unrealized net gain on available-for-sale securities—net					46				46
Minimum pension liability—net					(136)				(136)
Treasury stock utilized for acquisition							18	334	334
Other	1	—	36						36
Balance December 31, 1995	1,371	138	2,400	13,718	326	(2,340)	(96)	(3,230)	11,012
Net income				3,858					3,858
Cash dividends declared				(1,542)					(1,542)
Currency translation adjustment					(64)				(64)
Stock option transactions	7	—	248				20	312	560
Purchases of common stock							(2)	(54)	(54)
Employee benefit trust transaction—net			682			(636)			46
Unrealized net gain on available-for-sale securities—net					30				30
Other	—	—	56		(2)		—	8	62

Balance December 31, 1996	1,378	138	3,386	16,034	290	(2,976)	(87)	(2,964)	13,908
Net income				4,426					4,426
Cash dividends declared				(1,762)					(1,762)
Currency translation adjustment					(506)				(506)
Stock option transactions	9		686				4	136	822
Purchases of common stock							(11)	(1,172)	(1,172)
Employee benefit trusts transactions—net			2,344			(2,316)	—	14	52
Unrealized net gain on available-for-sale securities—net					40				40
Other	1		52		6				58
Balance December 31, 1997	**1,388**	**$138**	**$6,478**	**$18,698**	**$(170)**	**$(5,292)**	**(94)**	**$(3,986)**	**$15,866**

See Notes to Consolidated Financial Statements which are an integral part of these statements.

Consolidated Statement of Cash Flows

(millions of dollars)	Year Ended December 31 **1997**	1996	1995
Operating Activities			
Net income	**$ 4,426**	$ 3,858	$ 3,146
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization of intangibles	**1,004**	860	748
Deferred taxes and other	**48**	178	128
Changes in assets and liabilities, net of effect of businesses acquired and divested:			
Accounts receivable	**(1,006)**	(510)	(580)
Inventories	**(750)**	(298)	(50)
Prepaid and other assets	**(276)**	(416)	(342)
Accounts payable and accrued liabilities	**(52)**	132	640
Income taxes payable	**(254)**	46	176
Other deferred items	**118**	284	(224)
Net cash provided by operating activities	**3,258**	4,134	3,642
Investing Activities			
Purchases of property, plant and equipment	**(1,886)**	(1,548)	(1,392)
Purchases of short-term investments	**(442)**	(5,702)	(5,222)
Proceeds from redemptions of short-term investments	**58**	6,980	4,370
Purchases of long-term investments	**(152)**	(1,640)	(302)
Purchases and redemptions of short-term investments by financial subsidiaries	**90**	(22)	(60)
(Increase)/decrease in loans and long-term investments by financial subsidiaries	**(40)**	104	660
Acquisitions, net of cash acquired	**—**	(902)	(3,042)
Proceeds from the sale of businesses	**42**	706	—
Other investing activities	**286**	150	302
Net cash used in investing activities	**(2,044)**	(1,874)	(4,686)
Financing Activities			
Proceeds from issuances of long-term debt	**114**	1,272	1,004
Repayments of long-term debt	**(538)**	(1,608)	(104)
Increase/(decrease) in short-term debt	**740**	518	(888)
Purchases of common stock	**(1,172)**	(54)	(216)
Cash dividends paid	**(1,762)**	(1,542)	(1,318)
Stock option transactions	**822**	560	410
Other financing activities	**100**	90	74
Net cash used in financing activities	**(1,696)**	(764)	(1,038)
Effect of exchange rate changes on cash and cash equivalents	**(64)**	(2)	(28)
Net increase/(decrease) in cash and cash equivalents	**(546)**	1,494	(2,110)
Cash and cash equivalents at beginning of year	**2,300**	806	2,916
Cash and cash equivalents at end of year	**$ 1,754**	$ 2,300	$ 806
Supplemental Cash Flow Information			
Cash paid during the period for:			
Income taxes	**$ 1,712**	$ 1,418	$ 1,292
Interest	**302**	278	350

See Notes to Consolidated Financial Statements which are an integral part of these statements.

1. Significant Accounting Policies

A—Consolidation and Basis of Presentation

The consolidated financial statements include the parent company and all significant subsidiaries, including those operating outside the U.S. Balance sheet amounts for the foreign operations are as of November 30 of each year and income statement amounts are for the full year periods ending on the same date. All significant transactions among our businesses have been eliminated.

In preparing the financial statements, management must use some estimates and assumptions that may affect reported amounts and disclosures. Estimates are used when accounting for long-term contracts, depreciation, amortization, employee benefits and asset valuation allowances. We are also subject to risks and uncertainties that may cause actual results to differ from estimated results, such as changes in the health care environment, competition, foreign exchange and legislation. Risks and Uncertainties That May Affect Our Future Results, in Section C of this document, discusses these and other uncertainties.

B—Cash Equivalents

Cash equivalents include items almost as liquid as cash, such as demand deposits, certificates of deposit and time deposits with maturity periods of three months or less when purchased. If items meeting this definition are part of a larger investment pool, we classify them as "Short-term investments."

C—Inventories

We value inventories at cost or fair value, if lower. Cost is determined as follows:

- finished goods and work-in-process at average actual cost
- raw materials and supplies at average or latest actual cost.

"Last-in, first-out" (LIFO) usage applies to U.S. sourced pharmaceuticals and part of Animal Health inventories (approximately 11% of total inventories) and "first-in, first-out" usage applies to the rest. The replacement cost of LIFO inventories is not materially different from the LIFO value reported.

D—Long-Lived Assets

Long-lived assets include:

- property, plant and equipment—These assets are recorded at original cost and the cost of any significant improvements after purchase is added. We depreciate the cost evenly over the assets' useful lives. For tax purposes, accelerated depreciation methods are used as allowed by tax laws

- goodwill—Goodwill represents the difference between the purchase price of acquired businesses and the fair value of their net assets when accounted for by the purchase method of accounting. We amortize goodwill evenly over periods not exceeding 40 years
- other intangible assets—Other intangible assets are included in "Other assets, deferred taxes and deferred charges" in the Balance Sheet. We amortize these assets evenly over their estimated useful lives.

We review long-lived assets for impairment when events or changes in business conditions indicate that their full carrying value may not be recovered. We consider assets to be impaired and write them down to fair value if expected associated cash flows are less than the carrying amounts. Fair value is the present value of the expected associated cash flows.

E—Foreign Currency Translation

For most foreign operations, local currencies are considered their functional currencies. We translate assets and liabilities to their U.S. dollar equivalents at rates in effect at the balance sheet date and record translation adjustments in Shareholders' Equity in the Balance Sheet. We translate Statement of Income accounts at average rates for the period. Transaction adjustments are recorded in "Other deductions—net" in the Statement of Income.

For operations in highly inflationary economies, we translate the balance sheet items as follows:

- monetary items (that is, assets and liabilities that will be settled for cash) at rates in effect at the balance sheet date, with translation adjustments recorded in "Other deductions—net" in the Statement of Income
- non-monetary items at historical rates (that is, those in effect when the items were first recorded).

F—Stock Options

The exercise price of stock options granted equals the market price on the grant date. In general, there is no expense related to stock options.

G—Advertising Expense
We record advertising expense as follows:

- production costs as incurred
- costs of radio time, television time and space in publications deferred until the advertising first occurs.

Advertising expense totaled $1,896 million in 1997, $1,556 million in 1996 and $1,376 million in 1995.

H—Earnings Per Common Share
Statement of Financial Accounting Standards No. 128, *Earnings per Share,* which became effective in 1997, requires presentation of two calculations of earnings per common share. "Basic" earnings per common share equals net income divided by weighted average common shares outstanding during the period. "Diluted" earnings per common share equals net income divided by the sum of weighted average common shares outstanding during the period plus common stock equivalents. Common stock equivalents are shares assumed to be issued if outstanding stock options were exercised. We have restated all prior period amounts to reflect these calculations. All prior period amounts have also been restated for the 1997 stock split (see Note 12, Common Stock).

2. International Operations

Substantially all unremitted earnings of international subsidiaries are free of legal and contractual restrictions. The net currency translation adjustment included in "Currency translation adjustment and other" in the Balance Sheet was $(158) million in 1997, $348 million in 1996 and $412 million in 1995.

3. Financial Subsidiaries

Our financial subsidiaries include Healthco International Bank Europe (HIBE) and a small captive insurance company. HIBE periodically adjusts its loan portfolio to meet its business needs. Information about these subsidiaries follows:

Condensed Balance Sheet

(millions of dollars)	**1997**	1996	1995
Cash and interest-bearing deposits	**$ 230**	$ 156	$ 26
Eurosecurities and securities purchased under resale agreements	**—**	90	68
Loans—net	**816**	762	866
Other assets	**16**	16	16
Total assets	**$1,062**	$1,024	$ 976
Certificates of deposit and other liabilities	**$ 146**	$ 174	$ 170
Shareholders' equity	**916**	850	806
Total liabilities and shareholders' equity	**$1,062**	$1,024	$ 976

Condensed Statement of Income

(millions of dollars)	**1997**	1996	1995
Interest income	**$ 58**	$ 56	$ 88
Interest expense	**(4)**	(6)	(6)
Other income/(expense)—net	**26**	4	(12)
Net income	**$ 80**	$ 54	$ 70

4. Business Alliances

We have entered into agreements related to two new pharmaceutical products developed by other companies:

- Cholestron, a cholesterol-lowering medication, developed by Becker Chemicals, Ltd.
- Ceptinor, a medication to treat symptoms of Alzheimer's disease, developed by Chemcor, Inc.

Under copromotion agreements, these products are marketed and copromoted with alliance partners. We provide funds, staff and other resources to sell, market, promote and further develop these medications. In the Statement of Income, "Alliance revenue" represents revenues earned under the copromotion agreements (a percentage of net sales adjusted, in some cases, for certain specific costs). "Selling, informational and administrative expenses" in the Statement of Income include other expenses for selling, marketing and further developing these products.

We also have licenses to sell Cholestron and Ceptinor in certain foreign countries. For those licensed sales, we record "Net sales" instead of "Alliance revenue" and record related costs and expenses in the appropriate caption in the Statement of Income.

5. Financial Instruments

Most of our financial instruments are recorded in the Balance Sheet. Several "derivative" financial instruments are "off-balance-sheet" items.

A—Investments in Debt and Equity Securities
Information about our investments follows:

Condensed Balance Sheet

(millions of dollars)	**1997**	1996	1995
Amortized cost and fair value of held-to-maturity debt securities:*			
Corporate debt	**$1,252**	$1,204	$1,364
Certificates of deposit	**1,310**	1,314	700
Municipals	**112**	58	444
Other	**208**	162	372
Total held-to-maturity debt securities	**2,882**	2,738	2,880
Cost and fair value of available-for-sale debt securities	**1,372**	1,272	—
Cost of available-for-sale equity securities	**162**	162	136
Gross unrealized gains	**212**	146	100
Gross unrealized losses	**(8)**	(16)	(16)
Fair value of available-for-sale equity securities	**366**	292	220
Total investments	**$4,620**	$4,302	$3,100

**Gross unrealized gains and losses are immaterial.*

These investments are in the following captions in the Balance Sheet:

(millions of dollars)	**1997**	1996	1995
Cash and cash equivalents	**$1,272**	$1,280	$ 306
Short-term investments	**1,424**	974	2,218
Long-term loans and investments	**1,924**	2,048	576
Total investments	**$4,620**	$4,302	$3,100

The contractual maturities of the held-to-maturity and available-for-sale debt securities as of December 31, 1997 were as follows:

	Years				
(millions of dollars)	Within 1	Over 1 to 5	Over 5 to 10	Over 10	Total
Held-to-maturity debt securities:					
Corporate debt	$1,134	$108	$ 8	$ 2	$1,252
Certificates of deposit	1,292	18	—	—	1,310
Municipals	112	—	—	—	112
Other	158	—	30	20	208
Available-for-sale debt securities:					
Certificates of deposit	—	512	378	—	890
Corporate debt	—	182	300	—	482
Total debt securities	$2,696	$820	$716	$22	$4,254
Available-for-sale equity securities					366
Total investments					$4,620

B—Short-Term Borrowings

The weighted average effective interest rate on short-term borrowings outstanding at December 31 was 2.9% in 1997, 5.0% in 1996 and 5.2% in 1995. We had approximately $2.6 billion available to borrow under lines of credit at December 31, 1997.

C—Long-Term Debt

Information on long-term debt outstanding follows:

(millions of dollars)	**1997**	1996	1995
Floating-rate unsecured notes	**$1,372**	$1,272	$ —
Repurchase agreement obligation	**—**	—	998
6½% Notes due 1997	**—**	—	500
Other borrowings and mortgages	**86**	102	168
Total long-term debt	**$1,458**	$1,374	$1,666
Current portion not included above	**$ 12**	$ 522	$ 554

The floating-rate unsecured notes mature on various dates from 2001 to 2005 and they bear interest at a defined variable rate based on the commercial paper borrowing rate. The weighted average interest rate was 6.0% at December 31, 1997. These notes minimize credit risk on certain available-for-sale debt securities that may be used to satisfy the notes at maturity. The securities had a fair value equal to the amount of the notes at December 31, 1997.

The 1995 repurchase agreement related to a sale of securities that we were obligated to repurchase. The agreement was terminated in 1996 and the debt repaid.

Long-term debt outstanding at December 31, 1997 matures as follows:

(millions of dollars)	1999	2000	2001	2002	After 2002
Maturities	$8	$6	$374	$322	$748

D—Derivative Financial Instruments

Purpose

"Forward-exchange contracts," "currency swaps" and "purchased currency options" are used to reduce exposure to foreign exchange risks. Also, "interest rate swap" contracts are used to adjust interest rate exposures.

Accounting Policies

We consider derivative financial instruments to be "hedges" (that is, an offset of foreign exchange and interest rate risks) when certain criteria are met. Under hedge accounting for a purchased currency option, its impact on earnings is deferred until the recognition of the underlying hedged item (inventory) in earnings. We recognize the earnings impact of the other instruments during the terms of the contracts, along with the earnings impact of the items they offset.

Purchased currency options are recorded at cost and amortized evenly to operations through the expected inventory delivery date. Unrealized gains at the transaction date are included in the cost of the related inventory purchased.

As interest rates change, we accrue the difference between the debt interest rates recognized in the Statement of Income and the amounts payable to or receivable from counterparties under swap contracts. Likewise, amounts arising from currency swap contracts are accrued as exchange rates change.

The Financial Statements include the following items related to derivative and other financial instruments serving as hedges or offsets:

"Other assets, deferred taxes and deferred charges" include:

- purchased currency options
- net amounts receivable related to swap contracts.

"Other current liabilities" include:

- fair value of forward-exchange contracts
- net amounts payable related to swap contracts.

"Currency translation adjustment and other" include changes in the:

- foreign exchange translation of foreign debt
- fair value of forward-exchange contracts for net investment hedges.

"Other deductions—net" include:

- changes in the fair value of foreign exchange instruments and changes in foreign-denominated assets and liabilities
- payments under swap contracts to offset interest expense or foreign exchange losses
- amortization of discounts or premiums on currencies sold under forward-exchange contracts.

Our criteria to qualify for hedge accounting are:

Foreign currency instruments

- The instrument must relate to a foreign currency asset, liability or an anticipated transaction that is probable and whose characteristics and terms have been identified
- It must involve the same currency as the hedged item
- It must reduce the risk of foreign currency exchange movements on our operations.

Interest rate instruments

- The instrument must relate to an asset or a liability
- It must change the character of the interest rate by converting a variable rate to a fixed rate or vice versa.

If an existing instrument becomes ineffective (that is, it no longer meets the criteria described), it is reported at its fair value.

The following table summarizes the exposures hedged or offset by the various instruments we use:

		Maximum Maturity in Years		
Instrument	Exposure	**1997**	1996	1995
Forward-exchange contracts	Foreign currency assets and liabilities	**1**	1	1
	Net investments	**—**	.5	—
Purchase currency options	Inventory purchases and sales	**2**	2	4
Currency swaps	Debt principal	**—**	—	10
	Loans	**4**	2	4
Interest rate swaps	Debt interest	**2**	2	10

Instruments Outstanding

The notional amounts of derivative financial instruments do not represent actual amounts exchanged by the parties, but instead represent the amount of the item on which the contracts are based.

The notional amounts of our foreign currency and interest rate contracts follow:

(millions of dollars)	**1997**	1996	1995
Foreign currency contracts:			
Commitments to sell foreign currencies, primarily in exchange for U.S. dollars:			
U.K. pounds	**$1,096**	$1,128	$1,290
Japanese yen	**448**	188	80
German marks	**316**	262	134
French francs	**268**	386	476
Irish punt	**214**	224	208
Italian lira	**150**	94	32
Belgian francs	**124**	134	228
Other currencies	**336**	336	146
Net investment hedges:			
Japanese yen	**—**	1,230	—
Swiss francs	**—**	684	—
Commitments to purchase foreign currencies, primarily in exchange for U.S. dollars:			
Swiss francs	**374**	308	2
Irish punt	**184**	42	70
German marks	**146**	108	158
U.K. pounds	**120**	256	566
Japanese yen	**14**	14	78
Other currencies	**350**	294	308
Total forward-exchange contracts	**$4,140**	$5,688	$3,776
Currency swaps:			
U.K. pounds	**$ 80**	$ —	$ 998
Other currencies	**—**	90	120
Total currency swaps	**$ 80**	$ 90	$1,118
Purchased options, primarily for U.S. dollars:			
Japanese yen	**$ 396**	$ 442	$ 462
German marks	**260**	56	208
French francs	**92**	70	174
Belgian francs	**58**	50	112
Other currencies	**122**	116	38
Total purchased options	**$ 928**	$ 734	$ 994
Interest rate swap contracts:			
Japanese yen	**$ 810**	$ 856	—
Swiss francs	**—**	—	998
U.K. pounds	**—**	—	50
Other	**1,628**	1,864	700
Total interest rate swap contracts	**$2,438**	$2,720	$1,748

The 1995 U.K. pound currency and interest rate swaps related to a sale-and-repurchase financing agreement (see section C of this note) and effectively converted fixed rate U.K. pound debt to U.S. dollar variable rate debt. These contracts were terminated in December when the debt was repaid.

The Japanese yen and Swiss franc interest rate swaps effectively fixed the interest rate on floating rate debt as follows:

- the Japanese yen debt at 1.4% in 1997, 0.7% in 1996 and 1.3% in 1995
- the Swiss franc debt at 2.1% in 1997 and 1996.

The floating interest rates were based on "LIBOR" rates related to the contract currencies. The contracts outstanding at December 31, 1996 matured in December 1997.

E—Fair Value

The following methods and assumptions were used to estimate the fair value of derivative and other financial instruments at the balance sheet date:

- short-term financial instruments (cash equivalents, accounts receivable and payable, forward-exchange contracts, short-term investments and borrowings)—cost approximates fair value because of the short maturity period
- loans—cost approximates fair value because of the short interest reset period
- long-term investments, long-term debt, forward-exchange contracts and purchased currency options—fair value is based on market or dealer quotes
- interest rate and currency swap agreements—fair value is based on estimated cost to terminate the agreements (taking into account broker quotes, current interest rates and the counterparties' creditworthiness).

The differences between fair and carrying values were not material at December 31, 1997, 1996 or 1995.

F—Credit Risk

We periodically review the creditworthiness of counterparties to foreign exchange and interest rate agreements and do not expect to incur a loss from failure of any counterparties to perform under the agreements. In general, there is no requirement for collateral from customers. There are no significant concentrations of credit risk related to our financial instruments.

6. Property, Plant and Equipment

The major categories of property, plant and equipment follow:

(millions of dollars)	**1997**	1996	1995
Land	**$ 284**	$ 238	$ 190
Buildings	**3,364**	3,194	2,812
Machinery and equipment	**5,438**	5,022	4,690
Furniture, fixtures and other	**2,770**	2,582	2,200
Construction in progress	**1,060**	974	1,034
	12,916	12,010	10,926
Less: accumulated depreciation	**4,642**	4,310	3,980
Total property, plant and equipment	**$ 8,274**	$ 7,700	$ 6,946

7. Other Deductions—Net

Other deductions—net are summarized below:

(millions of dollars)	**1997**	1996	1995
Interest income	**$(312)**	$(270)	$(316)
Interest expense	**298**	340	410
Interest expense capitalized	**(4)**	(10)	(26)
Net interest (income)/expense	**(18)**	60	68
Amortization of goodwill and other intangibles	**136**	132	92
Net exchange losses	**56**	6	28
Other, net	**342**	354	334
Other deductions—net	**$ 516**	$ 552	$ 522

8. Taxes on Income

Income from continuing operations before taxes consisted of the following:

(millions of dollars)	**1997**	1996	1995
United States	**$2,658**	$2,130	$2,082
International	**3,518**	3,478	2,516
Total income from continuing operations before taxes	**$6,176**	$5,608	$4,598

The provision for taxes on income consisted of the following:

(millions of dollars)	**1997**	1996	1995
United States:			
Taxes currently payable:			
Federal	**$ 764**	$ 664	$ 682
State and local	**34**	108	82
Deferred income taxes	**(48)**	20	(44)
Total U.S. tax provision	**750**	792	720
International:			
Taxes currently payable	**1,002**	816	736
Deferred income taxes	**(22)**	130	20
Total international tax provision	**980**	946	756
Total provision for taxes on income	**$1,730**	$1,738	$1,476

Amounts are reflected in the above tables based on the location of the taxing authorities. As of December 31, 1997, we have not made a U.S. tax provision for approximately $1.9 billion on approximately $9.0 billion of unremitted earnings of our international subsidiaries. These earnings are expected, for the most part, to be reinvested overseas.

We operate a manufacturing subsidiary in Puerto Rico that benefits from a Puerto Rican incentive grant in effect through 2002. Under this grant, we are partially exempt from income, property and municipal taxes. For further information on U.S. taxation of Puerto Rican operations, see “Tax Legislation” in Section C, Risks and Uncertainties That May Affect Our Future Results.

Reconciliations of the U.S. statutory income tax rate to our effective tax rate follow:

(percentages)	**1997**	1996	1995
U.S. statutory income tax rate	**35.0**	35.0	35.0
Effect of partially tax-exempt operations in Puerto Rico	**(1.7)**	(3.5)	(5.8)
Effect of foreign operations	**(4.2)**	(2.9)	1.6
All other—net	**(1.1)**	2.4	1.3
Consolidated effective tax rate	**28.0**	31.0	32.1

Deferred taxes arise because of different treatment between financial statement accounting and tax accounting, known as "temporary differences." We record the tax effect of these temporary differences as "deferred tax assets" (generally items that can be used as a tax deduction or credit in future periods) and "deferred tax liabilities" (generally items that we received a tax deduction for, but have not yet recorded in the Statement of Income). The tax effects of the major items recorded as deferred tax assets and liabilities are:

	1997 Deferred Taxes		1996 Deferred Taxes		1995 Deferred Taxes	
(millions of dollars)	Assets	Liabs.	Assets	Liabs.	Assets	Liabs.
Prepaid/deferred items	**$ 518**	**$ 428**	$ 484	$ 312	$ 472	$ 386
Inventories	**520**	**130**	526	196	490	142
Property, plant and equipment	**62**	**736**	64	828	86	744
Employee benefits	**596**	**226**	482	210	554	200
Restructurings and special charge	**266**	—	314	—	430	—
Foreign tax credit carryforwards	**318**	—	130	—	220	—
Other carryforwards	**270**	—	502	—	306	—
All other	**240**	**184**	212	174	212	122
Subtotal	**2,790**	**1,704**	2,714	1,720	2,770	1,594
Valuation allowance	**(54)**	—	(56)	—	(60)	—
Total deferred taxes	**$2,736**	**$1,704**	$2,658	$1,720	$2,710	$1,594
Net deferred tax asset	**$1,032**		$ 938		$1,116	

These amounts, netted by taxing location, are in the following captions in the Balance Sheet:

(millions of dollars)	**1997**	1996	1995
Prepaid expenses, taxes and other assets	**$ 884**	$ 850	$ 938
Other assets, deferred taxes and deferred charges	**460**	594	510
Deferred taxes on income	**(312)**	(506)	(332)
Net deferred tax asset	**$1,032**	$ 938	$1,116

A valuation allowance is recorded because some items recorded as foreign deferred tax assets may not be deductible or creditable. The "foreign tax credit carryforwards" were generated from dividends paid by subsidiaries to the parent company between 1993 and 1997. We can carry these credits forward to various dates through 2002 and use them in payment of certain U.S. tax liabilities.

The Internal Revenue Service has completed its audits of our tax returns through 1992.

In November 1994, Belgian tax authorities notified Healthco Research and Development Company N.V./S.A. (HRDCO), an indirect, wholly owned subsidiary of our company, of a proposed adjustment to the taxable income of HRDCO for fiscal year 1992. The proposed adjustment arises from an assertion by the Belgian tax authorities of jurisdiction with respect to income resulting primarily from certain transfers of property by our non-Belgian subsidiaries to the Irish branch of HRDCO. In January 1995, HRDCO received an assessment from the tax authorities for additional taxes and interest of approximately $864 million and $194 million, respectively, relating to these matters. In January 1996, HRDCO received an assessment from the tax authorities, for fiscal year 1993, for additional taxes and interest of approximately $172 million and $36 million, respectively. The additional assessment arises from the same assertion by the Belgian tax authorities of jurisdiction with respect to all income of the Irish branch of HRDCO. Based upon the relevant facts regarding the Irish branch of HRDCO and the provisions of the Belgian tax laws and the written opinions of outside counsel, we believe that the assessments are without merit.

We believe that our accrued tax liabilities are adequate for all years after 1992.

9. Pension and Postretirement Benefits

Our pension plans cover most employees worldwide. Benefits depend on years of service and employee final average earnings. Participants vest in their benefits after as few as five years of service.

Our postretirement plans in the U.S. provide medical and life insurance benefits to retirees and their eligible dependents. Employees are eligible for benefits if they meet age and service requirements and qualify for retirement benefits.

We reserve the right to modify or terminate these plans.

Our funding policy is:

- to contribute annually to U.S. pension plans at a rate intended to remain at a level percentage of compensation. Since the major U.S. plan is overfunded, we have not made a contribution since 1992
- to fund international pension plans as required by local government and tax requirements.

We do not fund postretirement plans, but contribute to the plans as benefits are paid.

In 1997, the U.S. pension plan was amended to improve the benefit provisions. These changes contributed to most of the increases in the projected benefit obligation and the unrecognized prior service costs of the U.S. plan.

The following tables present the benefit obligations of the plans, the funded status of the pension plans and the assumptions used:

	Pension			Postretirement		
(percentages)	**1997**	1996	1995	**1997**	1996	1995
Assumptions:						
Discount rate:						
U.S. plans	**7.0**	7.5	7.5	**7.0**	7.5	7.5
International plans	**5.9**	6.5	6.4			
Rate of increase in salary levels:						
U.S. plans	**4.5**	4.5	5.5			
International plans	**3.9**	4.2	4.3			
(millions of dollars)						
Fair value of plan assets	**$5,586**	$4,820	$4,336			
Actuarial present value of accumulated benefit obligation:						
Vested	**$3,642**	$3,212	$3,116			
Non-vested	**540**	484	432			
Total	**4,182**	3,696	3,548			
Effect of future salary increases	**1,166**	564	576			
Projected benefit obligation	**$5,384**	$4,260	$4,124			
Postretirement benefit obligation for:						
Retirees				**$ 360**	$ 376	$ 394
Fully eligible active plan participants				**66**	66	64
Other active plan participants				**148**	128	122
Accumulated postretirement benefit obligation				**$ 574**	$ 570	$ 580
Plan assets in excess of / (less than) benefit obligation	**$ 238**	$ 560	$ 212	**$(574)**	$(570)	$(580)
Unrecognized overfunding at date of adoption	**(20)**	(30)	(36)	**—**	—	—
Unrecognized net (gains) / losses	**(172)**	(28)	258	**(48)**	(38)	(6)
Unrecognized prior service costs / (gains)	**620**	140	190	**(166)**	(216)	(266)
Minimum liability adjustment	**(392)**	(318)	(360)	**—**	—	—
Prepaid/(accrued) costs included in the Balance Sheet	**$ 274**	$ 324	$ 264	**$(788)**	$(824)	$(852)

The figures above include the following amounts for partially funded international pension plans:

(millions of dollars)	**1997**	1996	1995
Fair value of plan assets	**$ 588**	$ 638	$ 652
Accumulated benefit obligation	**$1,106**	$1,230	$1,240

The pension plan trustees invest plan assets primarily in stocks, bonds and short-term investments. At December 31, 1997, the major U.S. plan held approximately 3.5 million shares of our common stock with a fair value of approximately $522 million. The plan received approximately $6 million in dividends on these shares in 1997.

The annual cost related to these plans and the assumptions used consist of the following:

	Pension			Postretirement		
(percentages)	**1997**	1996	1995	**1997**	1996	1995
Assumptions:						
Expected long-term rate of return on plan assets:						
U.S. plans	**10.0**	10.0	10.0			
International plans	**7.5**	7.8	8.1			
(millions of dollars)						
Expected return on plan assets:						
Actual return	**$(982)**	$(650)	$(830)			
Deferred return	**566**	266	490			
Net expected return	**(416)**	(384)	(340)			
Service cost—benefits earned during the period	**210**	186	162	**$ 14**	$ 12	$ 10
Interest cost on benefit obligation	**290**	278	262	**38**	40	44
Net amortization and deferral	**62**	60	92	**(50)**	(48)	(48)
Net periodic cost	**$ 146**	$ 140	$ 176	**$ 2**	$ 4	$ 6

An average increase of 8.2% in the cost of covered health care benefits was assumed for 1998 and is projected to decrease to 5.2% after seven years and to then remain at that level.

A 1% increase in the medical trend rate assumed for postretirement benefits would cause an increase of $26.2 million in the accumulated benefit obligation at December 31, 1997 and an increase in the periodic cost of $1.8 million.

10. Savings and Investment Plans

We have savings and investment plans for most employees in the U.S., Puerto Rico, the U.K. and Ireland. Employees may contribute a portion of their salaries to the plans and we match a portion of the employee contributions. Our contributions were $82 million in 1997, $72 million in 1996 and $66 million in 1995.

11. Lease Commitments

We lease properties for use in our operations. In addition to rent, the leases require us to pay directly for taxes, insurance, maintenance and other operating expenses, or to pay higher rent when operating expenses increase. Rental expense, net of sublease income, was $278 million in 1997, $244 million in 1996 and $236 million in 1995. This table shows future minimum rental commitments under noncancellable leases at December 31, 1997:

(millions of dollars)	1998	1999	2000	2001	2002	After 2002
Lease commitments	$90	$84	$66	$48	$46	$572

12. Common Stock

We effected a two-for-one split of our common stock in the form of a 100% stock dividend in both 1997 and 1995. Both splits followed votes by shareholders to increase the number of authorized common shares. All share and per share information in this report reflects both splits.

The Board of Directors authorized us to repurchase up to $2 billion of our outstanding common stock through September 1998. In 1997, we repurchased approximately 11.4 million shares at an average price of $51 per share and approximately .6 million shares in 1996 at an average price of $44 per share.

13. Preferred Stock Purchase Rights

Preferred Stock Purchase Rights granted in 1987 expired in October 1997. Those rights were replaced by new Preferred Stock Purchase Rights that have a scheduled term through October 2007, although that may be extended or redeemed. One right was issued for each share of common stock issued by our company. These rights are not exercisable unless certain change-in-control events transpire, such as a person acquiring or obtaining the right to acquire beneficial ownership of 15% or more of our outstanding common

stock or an announcement of a tender offer for at least 30% of that stock. The rights are evidenced by corresponding common stock certificates and automatically trade with the common stock unless an event transpires that makes them exercisable. If the rights become exercisable, separate certificates evidencing the rights will be distributed and each right will entitle the holder to purchase from our company a new series of preferred stock at a defined price. The preferred stock, in addition to preferred dividend and liquidation rights, will entitle the holder to vote with the company's common stock.

The rights are redeemable by us at a fixed price until 10 days, or longer as determined by the Board, after certain defined events, or at any time prior to the expiration of the rights. We have reserved 3.0 million preferred shares to be issued pursuant to these rights. No such shares have yet been issued. At the present time, the rights have no dilutive effect on the earnings per common share calculation.

14. Employee Benefit Trusts

In 1993, we sold 40 million shares of treasury stock to the Healthco Inc. Grantor Trust in exchange for a $1.2 billion note. The Trust is used primarily to fund our benefit plans including the stock option plan. The Balance Sheet reflects the fair value of shares owned by the Trust as a reduction of Shareholders' Equity, representing unearned benefit costs. This amount is reduced as benefits are satisfied.

The Trust released approximately 630,000 shares in 1997, 1,260,000 shares in 1996 and 1,660,000 shares in 1995. We record compensation expense for the benefit plans, other than stock options, based on the fair value of the shares when released.

15. Stock Option and Performance Awards

We may grant stock options to any employee, including officers, under our Stock and Incentive Plan. Options are exercisable after five years or less, subject to continuous employment and certain other conditions and expire 10 years after the grant date. Once exercisable, the employee can purchase shares of our common stock at the market price on the date we granted the option.

The Plan also allows for stock appreciation rights, stock awards and performance awards. In 1996, shareholders approved amendments to increase the shares available in the Plan and to extend its term through 2005.

The following table summarizes information concerning options outstanding under the Plan at December 31, 1997:

(thousands of shares)	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at 12/31/97	Weighted Average Remaining Contractual Term (Years)	Weighted Average Exercise Price	Number Exercisable at 12/31/97	Weighted Average Exercise Price
$ 0—$10	6,071	1.6	$ 7.44	6,071	$ 7.44
10— 20	24,583	5.7	16.58	24,249	16.57
20— 30	22,249	6.1	22.45	17,756	21.94
30— 40	17,192	8.6	37.35	7,714	37.25
50— 60	14,204	9.6	55.04	—	—

The following table summarizes the activity for the Plan:

		Under Option	
(thousands of shares)	Shares Available for Grant	Shares	Weighted Average Exercise Price for Share
Balance January 1, 1995	19,570	88,484	$16.13
Granted	(14,104)	14,104	24.50
Exercised	—	(15,096)	14.01
Cancelled	1,684	(1,684)	18.85
Balance December 31, 1995	7,150	85,808	18.37
Authorized	46,000	—	—
Granted	(18,820)	18,820	37.25
Exercised	—	(17,466)	13.44
Cancelled	684	(734)	24.00
Balance December 31, 1996	35,014	86,428	21.62
Granted	(14,204)	14,204	55.04
Exercised	—	(15,661)	16.15
Cancelled	653	(672)	38.68
Balance December 31, 1997	21,463	84,299	28.17

The weighted-average fair value per stock option granted was $16.77 for the 1997 options, $10.90 for the 1996 options and $6.46 for those granted in 1995. We estimated the fair values using the Black-Scholes option pricing model, modified for dividends and using the following assumptions:

	1997	1996	1995
Expected dividend yield	**1.76%**	1.97%	2.85%
Risk-free interest rate	**6.23%**	6.38%	6.26%
Expected stock price volatility	**25.56%**	25.45%	26.00%
Expected term until exercise (years)	**5.50**	5.25	5.25

We do not record compensation expense for stock option grants. The following table summarizes results as if we had recorded compensation expense for the 1997, 1996 and 1995 option grants:

(millions of dollars, except per share data)	**1997**	1996	1995
Net income:			
As reported	**$4,426**	$3,858	$3,146
Pro forma	**4,174**	3,720	3,118
Basic earnings per share:			
As reported	**$ 3.52**	3.10	2.56
Pro forma	**3.32**	2.98	2.54
Diluted earnings per share:			
As reported	**$ 3.40**	$ 3.00	$ 2.50
Pro forma	**3.20**	2.88	2.48

These figures reflect only the impact of grants since January 1, 1995 and reflect only part of the possible compensation expense that we amortize over the vesting period of the grants (up to five years). In future years, therefore, the effect on net income and earnings per common share may differ from those shown above.

The Performance-Contingent Share Award Program was established effective in 1993 to provide executives and other key employees the right to earn common stock awards. We determine the award payouts after the performance period ends, based on specific performance criteria. Under the program, up to 40 million shares may be awarded. We awarded approximately 449,000 shares in 1997, approximately 320,000 shares in 1996 and approximately 92,000 shares in 1995. At December 31, 1997, program participants had the right to earn up to 5.2 million additional shares. Compensation expense related to the program was $148 million in 1997, $62 million in 1996 and $30 million in 1995.

16. Acquisitions

In 1996, we acquired, for cash:

- certain cosmetic, dietetic and other over-the-counter products businesses in the U.S. and Italy
- three businesses operating within the medical technology industry.

In 1995, we acquired, for cash:

- subsidiaries and net assets of the Walker Industries plc animal health business
- SunSkin Consumer Health Care products.

We recorded all of these acquisitions under the purchase method of accounting and included their operating results in the Financial Statements from their respective acquisition dates. Results of operations, assuming the 1996 acquisitions had occurred on January 1, would not be materially different from those reported.

17. Discontinued Operations

In 1996, we sold our food science business and have reported its results as discontinued operations. Following is a summary of its results:

(millions of dollars)	1996	1995
Net sales	$ 94	$656
Income before provision for taxes on income	$ —	$ 62
Provision for taxes on income	—	18
Net income	$ —	$ 44

At December 31, 1995, “Prepaid expenses, taxes and other assets” in the Balance Sheet included the net assets of the food science business, which totaled $660 million.

18. Insurance

We maintain insurance coverage adequate for our needs. Under our insurance contracts, we usually accept self-insured retentions appropriate for our specific business risks.

19. Litigation

The Company is involved in a number of claims and litigations, including product liability claims and litigations considered normal in the nature of its businesses. These include suits involving various pharmaceutical and hospital products that allege either reaction to or injury from use of the product. In addition, from time to time the Company is involved in, or is the subject of, various governmental or agency inquiries or investigations relating to its businesses. The Company believes that most if not all of these cases are without merit. The Company believes that these actions are without merit and their resolution should not have a material adverse effect on the financial position or the results of operations of the Company.

For information on income tax adjustments proposed by the Belgian tax authorities, see Note 8, Taxes on Income.

20. Subsequent Event

In January 1998, we completed the sale of the Diagnostix business to Foster Corporation for $850 million. In connection with this transaction, a gain is expected to be recorded in the first quarter of 1998. Diagnostix manufactures a line of electrosurgical and ultrasonic systems and disposables. The Diagnostix business is not significant to our financial position or results of operations.

21. Segment Information and Geographic Data

We operate in three business segments. Each separately managed segment offers different products requiring different R&D, production, marketing and distribution strategies. The three segments are:

- Health care—a broad line of pharmaceutical products (including treatments for heart diseases, infectious diseases, central nervous system disorders, diabetes, arthritis/inflammation and allergies)
- Animal health—products for livestock and pets including antibiotic and feed supplements, vaccines and other veterinary items
- Consumer health care—over-the-counter health care and personal care products.

We sell our products primarily to customers in the wholesaler sector. In 1997, sales to one wholesaler accounted for 10% of total revenues. Sales to our four largest wholesalers in 1997 represented 34% of total revenues. These sales were concentrated in the health care segment.

Revenues were in excess of $10 million in each of 44 countries outside the U.S. in 1997. The U.S. was the only country to contribute more than 10% to total revenues.

Segment Information

(millions of dollars)		Health Care	Animal Health	Consumer Health Care	Corporate/ Other	Consolidated
Total revenues	**1997**	**$21,378**[1]	**$2,658**	**$972**	**$ —**	**$25,008**[1]
	1996	19,260	2,444	908	—	22,612
	1995	16,818	2,438	786	—	20,042
Identifiable assets[2]	**1997**	**14,116**	**4,392**	**966**	**11,198**	**30,672**
	1996	13,372	4,486	946	10,530	29,334
	1995	11,114	4,138	614	9,592[3]	25,458
Property, plant and equipment additions[2]	**1997**	**1,468**	**138**	**36**	**244**	**1,886**
	1996	1,188	174	44	142	1,548
	1995	1,030	148	56	158[3]	1,392
Depreciation and amortization[2]	**1997**	**786**	**150**	**36**	**32**	**1,004**
	1996	638	164	30	28	860
	1995	542	114	24	68[3]	748

[1]*Includes alliance revenue of $1,264 million.*

[2]*Certain production facilities are shared by various segments. Property, plant and equipment, as well as capital additions and depreciation, are allocated based on physical production. Corporate assets are primarily cash, short-term investments and long-term marketable securities.*

[3]*Includes amounts for the food science business which was sold in 1996.*

For information about segment profits, reference is made to the following tables in the MD&A:

Animal Health segment	Table on page 16
Consumer Health segment	Table on page 20
Health Care segment	*omitted*

Geographic Data

(millions of dollars)		United States[6]	Europe	Asia	Canada/ Latin America	Africa/ Middle East	Corporate/ Other	Adjustments/ Eliminations	Consolidated
Total revenues	**1997**	**$13,734**	**$5,706**	**$3,350**	**$1,698**	**520**	**$ —**	**$ —**	**$25,008**[1]
	1996	11,882	5,546	3,196	1,500	488	$ —	$ —	$22,612
	1995	10,226	4,888	3,076	1,392	460	$ —	$ —	$20,042
Intercompany sales	**1997**	**392**	**1,762**	**150**	**128**	**22**	**—**	**(2,454)**	**—**
	1996	394	1,626	168	70	18	—	(2,276)	—
	1995	350	1,384	150	58	20	—	(1,962)	—
Total	**1997**	**14,126**	**7,468**	**3,500**	**1,826**	**542**	**—**	**(2,454)**	**25,008**[1]
	1996	12,276	7,172	3,364	1,570	506	—	(2,276)	22,612
	1995	10,576	6,272	3,226	1,450	480	—	(1,962)	20,042
Geographic profit/(loss)	**1997**	**4,502**	**2,024**	**466**	**84**	**14**	**(744)**[2]	**(170)**	**6,176**[3]
	1996	4,036	2,026	500	58	(10)	(846)[2]	(156)	5,608[3]
	1995	3,256	1,556	522	98	24	(764)[2]	(94)	4,598[3]
Identifiable assets[4] [7]	**1997**	**9,330**	**8,634**	**2,404**	**1,140**	**302**	**11,198**	**(2,336)**	**30,672**
	1996	8,848	8,144	2,556	1,212	348	10,530	(2,304)	29,334
	1995	6,398	7,294	2,486	1,224	386	9,592[5]	(1,922)	25,458

[1]*Includes alliance revenue of $632 million.*

[2]*Includes interest/(expense) and corporate expenses. Also includes other income/(expense) of the financial subsidiaries (see Note 3, "Financial Subsidiaries").*

[3]*Consolidated total equals income from continuing operations before provision for taxes on income and minority interests.*

[4]*Certain production facilities are shared by various segments. Property, plant and equipment, as well as capital additions and depreciation, are allocated based on physical production. Corporate assets are primarily cash, short-term investments and long-term marketable securities.*

[5]*Includes amounts for the food science business which was sold in 1996.*

[6]*Includes operations in Puerto Rico.*

[7]*Products are transferred between geographic areas for additional processing and ultimate sale, on a basis intended to recognize economic and competitive circumstances in the market of end use. These figures reflect the physical location of assets even though these assets provide goods and services to other areas.*

Quarterly Consolidated Financial Data (Unaudited)

	Quarter				
(millions of dollars, except per share data)	First	Second	Third	Fourth	Year
1997					
Net sales	$6,004	$5,708	$5,998	$6,666	$24,376
Alliance revenue	(2)	118	190	326	632
Total revenues	6,002	5,826	6,188	6,992	25,008
Costs and expenses					
Cost of sales	1,090	1,020	1,092	1,346	4,548
Selling, informational and administrative expenses	2,228	2,490	2,372	2,822	9,912
Research and development expenses	826	922	954	1,154	3,856
Other deductions—net	134	122	146	114	516
Income before provision for taxes on income and minority interests	1,724	1,272	1,624	1,556	6,176
Provision for taxes on income	518	350	426	436	1,730
Minority interests	2	8	6	4	20
Net income	$1,204	$ 914	$1,192	$1,116	$ 4,426
Earnings per common share—basic*	$ .96	$ .72	$ .96	$ .88	$ 3.52
Earnings per common share—diluted*	$ .92	$ .70	$ .92	$ .86	$ 3.40
Cash dividends paid per common share	$ .34	$ .34	$ .34	$ .34	$ 1.36
1996					
Net sales	$5,364	$5,322	$5,606	$6,320	$22,612
Costs and expenses					
Cost of sales	1,026	1,042	1,044	1,240	4,352
Selling, informational and administrative expenses	1,988	2,166	2,080	2,498	8,732
Research and development expenses	732	844	812	980	3,368
Other deductions—net	114	122	172	144	552
Income before provision for taxes on income and minority interests	1,504	1,148	1,498	1,458	5,608
Provision for taxes on income	466	356	464	452	1,738
Minority interests	4	4	6	(2)	12
Net income	$1,034	$ 788	$1,028	$1,008	$ 3,858
Earnings per common share—basic*	$ .84	$ .62	$ .82	$ .82	$ 3.10
Earnings per common share—diluted*	$ .80	$ .62	$ .80	$ .78	$ 3.00
Cash dividends paid per common share	$ .30	$ .30	$ .30	$ .30	$ 1.20

**Earnings per common share have been recomputed for the adoption of SFAS No. 128. For additional details, see Note 1-H,* Significant Accounting Policies—Earnings Per Common Share.

Financial Statement Schedules

Schedules are omitted because they are not required or the information is given elsewhere in the financial statements. The financial statements of unconsolidated subsidiaries are omitted because, considered in the aggregate, they would not constitute a significant subsidiary.

F. Corporate Wide Matters

Employees

In our innovation-intensive business, our employees are vital to our success. We believe we have good relationships with our employees. As of December 31, 1997, we employed approximately 49,200 people in our operations throughout the world. Geographically, this total breaks down as follows:

- United States, 20,700
- Europe, 14,400
- Asia, 7,700
- Canada/Latin America, 5,000
- Africa/Middle East, 1,400.

Properties

Our world headquarters are located in several buildings in Boston. We own two of these buildings, including our main 33-story office tower, and rent space in others nearby. The 33-story office tower is located on a site we have leased under a long-term ground lease. Altogether, our headquarters operations occupy over one million square feet of owned and leased office space in Boston.

Our major research and development facilities are located in manufacturing/R&D complexes that we own containing multiple buildings in Groton, Connecticut and Sandwich, England. The buildings at our Groton facility currently contain approximately three million square feet of floor space. Approximately 1.2 million square feet is used for manufacturing, and the rest is used for research and development. An additional 550,000 square foot laboratory building, which is expected to house approximately 700 new research employees, is currently under construction. The Company also plans to begin construction in 1998 on an additional 400,000 square foot facility on a 24 acre site in nearby New London, Connecticut, to house an initial 1,300 employees from the Company's research operations.

Buildings on our 340 acre Bath, England campus house research and a production plant. These facilities contain almost two million square feet of floor space, approximately half of which is used for research and development. An additional 540,000 square feet of new research space is under construction.

We own other important research facilities in Nagoya, Japan; Amboise, France; and Terre Haute, Indiana. A number of smaller research and development operations around the world focus principally on their local markets. As discussed above, we have been expanding our research and development facilities in recent years to meet the challenges of handling growing research activities. Altogether in 1997, we commenced construction on over one million square feet of research facilities at our sites in Groton, Sandwich and Nagoya.

We have major product production plants at five sites:

- Sao Paulo, Brazil
- Beijing, China
- Bath, England
- Caen, France
- Munich, Germany.

In general, our properties are well maintained, adequate and suitable to their purposes. The growth of our businesses has created space pressures for certain operations, however. We have responded to such challenges with plans to provide appropriate facilities as needs are demonstrated. Note 6 to our consolidated financial statements, Property, Plant and Equipment, which discloses amounts invested in land, buildings and equipment, and the discussion of investing activities under the heading Summary of Cash Flows, which describes our capital expenditures. See, also, the discussion under Note 11 entitled Lease Commitments.

G. Submission of Matters to a Vote of Security Holders

Not applicable.

H. Executive Officers of the Company

As of March 10, 1998, the following executive officers of the Company hold the offices indicated until their successors are chosen and qualified after the next annual meeting of shareholders.

NAME	POSITION
James L. McNab	Vice President; President - Animal Health Group
Sylvia B. Haskins	Vice President, Federal Government Relations
D. Murray Powers	Senior Vice President, Corporate Affairs; Secretary and Corporate Counsel; Member of the Corporate Management Committee
Grace A. Larkin	Vice President, Corporate Quality Assurance
William N. Buhner	Vice President; Senior Vice President, Product Development - Healthco Pharmaceuticals Group
Barry G. Miller	Vice President; Treasurer
Harold S. Wright	Senior Vice President; General Counsel
Roberta J. Williams	Senior Vice President - Employee Resources; Member of the Corporate Management Committee
Adam L. Shea	Vice President; Controller
Michael E. Groves	Senior Vice President and Chief Financial Officer; Member of the Corporate Management Committee
Daniel R. Morrison	Chairman of the Board and Chief Executive Officer

Information concerning Messrs. Morrison, Powers and Buhner is contained in, and incorporated here by reference from, the discussion under the captions Nominees for Directors Whose Terms Expire in 2001, Directors Whose Terms Expire in 2000 and Named Executive Officers Who Are Not Directors in our Proxy Statement for the 1998 Annual Meeting of Shareholders.

[detailed biographies omitted]

I. Market for the Company's Common Equity and Related Stockholder Matters

The principal market for our Common Stock is the New York Stock Exchange. It is also listed on the London and Swiss Stock Exchanges and is traded on various United States regional stock exchanges.

J. Changes in and Disagreements with Accountants on Accounting and Financial Disclosures

Not applicable.

K. Directors and Executive Officers of the Company

Information about Directors of the Company is incorporated by reference from the discussion under Item 1 of our Proxy Statement for the 1998 Annual Meeting of Shareholders. The balance of the response to this item is contained in the discussion entitled Executive Officers of the Company in Section H of this report.

L. Executive Compensation

Information about executive compensation is incorporated by reference from the discussion under the heading Executive Compensation in our Proxy Statement for the 1998 Annual Meeting of Shareholders.

M. Security Ownership of Certain Beneficial Owners and Management

Information about security ownership of certain beneficial owners and management is incorporated by reference from the discussion under the heading Security Ownership of Directors and Officers in Item 1 of our Proxy Statement for the 1998 Annual Meeting of Shareholders.

N. Certain Relationships and Related Transactions

Information about certain relationships and transactions with related parties is incorporated herein by reference from the discussion under the heading Related Transactions in our Proxy Statement for the 1998 Annual Meeting of Shareholders.

O. Exhibits

Exhibits have been omitted.

P. Reports on Form 8-K

The Company filed a report on Form 8-K during the last quarter of 1997 dated October 9, 1997.

Q. Signatures

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Healthco Inc.

/s/
By:____________________________
President, Secretary and Corporate Counsel