MCKESSON CORP
Form 10-Q
July 29, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2015

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

For the transition period from to
Commission File Number: 1-13252

McKESSON CORPORATION
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	94-3207296 (I.R.S. Employer Identification No.)
One Post Street, San Francisco, California (Address of principal executive offices)	94104 (Zip Code)

(415) 983-8300
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities 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 o

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

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding as of	June 30, 2015
Common stock, $0.01 par value	232,403,216 shares	

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PART I—FINANCIAL INFORMATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In millions, except per share amounts)
(Unaudited)

	Quarter Ended June 30,	
	2015	2014
Revenues	$47,546	$43,476
Cost of Sales	(44,698)	(40,744)
Gross Profit	2,848	2,732
Operating Expenses	(1,917)	(2,051)
Operating Income	931	681
Other Income, Net	13	19
Interest Expense	(89)	(96)
Income from Continuing Operations Before Income Taxes	855	604
Income Tax Expense	(256)	(185)
Income from Continuing Operations	599	419
Loss from Discontinued Operations, Net of Tax	(10)	(8)
Net Income	589	411
Net Income Attributable to Noncontrolling Interests	(13)	(8)
Net Income Attributable to McKesson Corporation	$576	$403
Earnings (Loss) Per Common Share Attributable to McKesson Corporation		
Diluted		
Continuing operations	$2.50	$1.76
Discontinued operations	(0.05)	(0.04)
Total	$2.45	$1.72
Basic		
Continuing operations	$2.53	$1.79
Discontinued operations	(0.04)	(0.04)
Total	$2.49	$1.75
Dividends Declared Per Common Share	$0.24	$0.24
Weighted Average Common Shares		
Diluted	235	235
Basic	232	231

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CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In millions)
(Unaudited)

	Quarter Ended June 30,	
	2015	2014
Net Income	$589	$411
Other Comprehensive Income (Loss), Net of Tax		
Foreign currency translation adjustments arising during period	347	98
Unrealized gains (losses) on cash flow hedges arising during period	4	(2)
Retirement-related benefit plans	(28)	2
Other Comprehensive Income (Loss), Net of Tax	323	98
Comprehensive Income	912	509
Comprehensive Loss (Income) Attributable to Noncontrolling Interests	(57)	4
Comprehensive Income Attributable to McKesson Corporation	$855	$513

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CONDENSED CONSOLIDATED BALANCE SHEETS
(In millions, except per share amounts)
(Unaudited)

	June 30, 2015	March 31, 2015
ASSETS		
Current Assets		
Cash and cash equivalents	$5,635	$5,341
Receivables, net	16,684	15,914
Inventories, net	14,932	14,296
Prepaid expenses and other	1,320	1,119
Total Current Assets	38,571	36,670
Property, Plant and Equipment, Net	2,100	2,045
Goodwill	9,949	9,817
Intangible Assets, Net	3,426	3,441
Other Assets	1,879	1,897
Total Assets	$55,925	$53,870
LIABILITIES, REDEEMABLE NONCONTROLLING INTERESTS AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Drafts and accounts payable	$26,319	$25,166
Short-term borrowings	144	135
Deferred revenue	939	1,078
Deferred tax liabilities	1,869	1,820
Current portion of long-term debt	1,510	1,529
Other accrued liabilities	3,892	3,769
Total Current Liabilities	34,673	33,497
Long-Term Debt	8,142	8,180
Other Noncurrent Liabilities	2,741	2,722
Commitments and Contingent Liabilities (Note 13)		
Redeemable Noncontrolling Interests	1,430	1,386
McKesson Corporation Stockholders' Equity		
Preferred stock, $0.01 par value, 100 shares authorized, no shares issued or outstanding	—	—
Common stock, $0.01 par value, 800 shares authorized at June 30, 2015 and March 31, 2015, 385 and 384 shares issued at June 30, 2015 and March 31, 2015	4	4
Additional Paid-in Capital	7,121	6,968
Retained Earnings	13,227	12,705
Accumulated Other Comprehensive Loss	(1,434)	(1,713)
Other	(4)	(7)
Treasury Shares, at Cost, 153 and 152 at June 30, 2015 and March 31, 2015	(10,061)	(9,956)
Total McKesson Corporation Stockholders' Equity	8,853	8,001
Noncontrolling Interests	86	84
Total Equity	8,939	8,085
Total Liabilities, Redeemable Noncontrolling Interests and Equity	$55,925	$53,870

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McKESSON CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In millions)
(Unaudited)

	Quarter Ended June 30,	
	2015	2014
Operating Activities		
Net income	$589	$411
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation and amortization	229	280
Deferred taxes	23	138
Charges associated with last-in-first-out inventory method	91	98
Other non-cash items	(31)	13
Changes in operating assets and liabilities, net of acquisitions:		
Receivables	(749)	(693)
Inventories	(635)	(893)
Drafts and accounts payable	1,003	1,367
Deferred revenue	(126)	(134)
Taxes	205	(134)
Other	(145)	(271)
Net cash provided by operating activities	454	182
Investing Activities		
Property acquisitions	(77)	(83)
Capitalized software expenditures	(43)	(33)
Acquisitions, net of cash and cash equivalents acquired	(6)	(14)
Proceeds from sale of business	84	—
Other	25	18
Net cash used in investing activities	(17)	(112)
Financing Activities		
Proceeds from short-term borrowings	531	905
Repayments of short-term borrowings	(534)	(747)
Proceeds from issuances of long-term debt	—	6
Repayments of long-term debt	(96)	(228)
Common stock transactions:		
Issuances	38	34
Share repurchases, including shares surrendered for tax withholding	(105)	(102)
Dividends paid	(59)	(59)
Other	22	24
Net cash used in financing activities	(203)	(167)
Effect of exchange rate changes on cash and cash equivalents	60	9
Net increase (decrease) in cash and cash equivalents	294	(88)
Cash and cash equivalents at beginning of period	5,341	4,193
Cash and cash equivalents at end of period	$5,635	$4,105

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FINANCIAL NOTES
(UNAUDITED)

1. Significant Accounting Policies

Basis of Presentation: The condensed consolidated financial statements of McKesson Corporation (“McKesson,” the “Company,” or “we” and other similar pronouns) include the financial statements of all wholly-owned subsidiaries and majority owned or controlled companies. We also evaluate our ownership, contractual and other interests in entities to determine if they are variable interest entities (“VIEs”), if we have a variable interest in those entities and the nature and extent of those interests. These evaluations are highly complex and involve judgment and the use of estimates and assumptions based on available historical information and management’s judgment, among other factors. Based on our evaluations, if we determine we are the primary beneficiary of such VIEs, we consolidate such entities into our financial statements. Investments in business entities in which we do not have control, but have the ability to exercise significant influence over operating and financial policies, are accounted for using the equity method and our proportionate share of income or loss is recorded in Other Income, Net. Intercompany transactions and balances have been eliminated. The condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial reporting and the rules and regulations of the U.S. Securities and Exchange Commission (“SEC”) and, therefore, do not include all information and footnote disclosures normally included in the annual consolidated financial statements.

To prepare the financial statements in conformity with GAAP, management must make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of these financial statements and income and expenses during the reporting period. Actual amounts may differ from these estimated amounts. In our opinion, the accompanying unaudited condensed consolidated financial statements include all normal recurring adjustments necessary for a fair presentation of our financial position, results of operations and cash flows for the interim periods presented.

The results of operations for the quarter ended June 30, 2015 are not necessarily indicative of the results that may be expected for the entire year. These interim financial statements should be read in conjunction with the annual audited financial statements, accounting policies and financial notes included in our Annual Report on Form 10-K for the fiscal year ended March 31, 2015 previously filed with the SEC on May 12, 2015 (“2015 Annual Report”).

Certain prior period amounts have been reclassified to conform to the current period presentation.

The Company’s fiscal year begins on April 1 and ends on March 31. Unless otherwise noted, all references to a particular year shall mean the Company’s fiscal year.

Recently Adopted Accounting Pronouncements

Discontinued Operations: In the first quarter of 2016, we adopted amended guidance for reporting of discontinued operations and disclosures of disposals of components. The amended guidance revises the criteria for disposals to qualify as discontinued operations and permits significant continuing involvement and continuing cash flows with the discontinued operation. In addition, the amended guidance requires additional disclosures for discontinued operations and new disclosures for individually material disposal transactions that do not meet the definition of a discontinued operation. Refer to Financial Notes 4 and 5, “Divestiture of a Business” and “Discontinued Operations,” for more information regarding the impact of this amended guidance on our condensed consolidated financial statements.

Recently Issued Accounting Pronouncements Not Yet Adopted

Inventory: In July 2015, amended guidance was issued for the subsequent measurement of inventory. The amended guidance requires entities to measure inventory at the lower of cost or net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. The requirement would replace the current lower of cost or market evaluation. Accounting guidance is unchanged for inventory measured using last-in, first-out (“LIFO”) or the retail method. The amended guidance will become effective for us commencing in the first quarter of 2018. Early adoption is permitted. We are currently evaluating the impact of this amended guidance on our condensed consolidated financial statements.

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Fair Value Measurement: In May 2015, amended guidance was issued that limits disclosures and removes the requirement to categorize investments within the fair value hierarchy if the fair value of the investment is measured using the net asset value per share practical expedient. The amended guidance will become effective for us commencing in the first quarter of 2017. Early adoption is permitted. We are currently evaluating the impact of this amended guidance on our condensed consolidated financial statements.

Fees Paid in a Cloud Computing Arrangement: In April 2015, amended guidance was issued for a customer's accounting for fees paid in a cloud computing arrangement. The amended guidance requires customers to determine whether or not an arrangement contains a software license element. If the arrangement contains a software element, the related fees paid should be accounted for as an acquisition of a software license. If the arrangement does not contain a software license, it is accounted for as a service contract. The amended guidance will become effective for us commencing in the first quarter of 2017. Early adoption is permitted. We are currently evaluating the impact of this amended guidance on our condensed consolidated financial statements.

Debt Issuance Costs: In April 2015, amended guidance was issued for the balance sheet presentation of debt issuance costs. The amended guidance requires debt issuance costs related to a recognized debt liability to be reported in the balance sheet as a direct deduction from the carrying amount of that debt liability. The recognition and measurement guidance for debt issuance costs are not affected by the amended guidance. The amended guidance will become effective for us commencing in the first quarter of 2017. Early adoption is permitted. We do not expect the adoption of this guidance to have a material effect on our condensed consolidated financial statements.

Consolidation: In February 2015, amended guidance was issued for consolidating legal entities in which a reporting entity holds a variable interest. The amended guidance modifies the evaluation of whether limited partnerships and similar legal entities are VIEs and changes the consolidation analysis of reporting entities that are involved with VIEs that have fee arrangements and related party relationships. The amended guidance will become effective for us commencing in the first quarter of 2017. Early adoption is permitted. We are currently evaluating the impact of this amended guidance on our condensed consolidated financial statements.

Revenue Recognition: In May 2014, amended guidance was issued for recognizing revenue from contracts with customers. The amended guidance eliminates industry specific guidance and applies to all companies. Revenues will be recognized when an entity satisfies a performance obligation by transferring control of a promised good or service to a customer in an amount that reflects the consideration to which the entity expects to be entitled for that good or service. Revenue from a contract that contains multiple performance obligations is allocated to each performance obligation generally on a relative standalone selling price basis. The amended guidance also requires additional quantitative and qualitative disclosures. As a result of a July 2015 decision by the Financial Accounting Standards Board, the amended guidance is effective for us commencing in the first quarter of 2019. The amended guidance allows for either full retrospective adoption or modified retrospective adoption. Early adoption is permitted but not prior to our first quarter of 2018. We are currently evaluating the impact of this amended guidance on our condensed consolidated financial statements.

2. Business Combinations

On February 6, 2014, we completed the acquisition of 77.6% of the then outstanding common shares of Celesio AG ("Celesio") and certain convertible bonds of Celesio for cash consideration of $4.5 billion, net of cash acquired. Celesio is an international wholesale and retail company and a provider of logistics and services to the pharmaceutical and healthcare sectors. Celesio's headquarters is in Stuttgart, Germany and it operates in 14 countries around the world. The fair value measurements of the assets acquired and liabilities assumed of Celesio as of the acquisition date were finalized upon completion of the measurement period in the fourth quarter of 2015. The refinements did not have a significant impact on our consolidated statements of operations, balance sheets or cash flows in any period and, therefore, were not retrospectively adjusted in our financial statements. Financial results for Celesio are included within our International pharmaceutical distribution and services business, which is part of our Distribution Solutions segment, since the date of the acquisition.

During the last two years, we also completed a number of smaller acquisitions within our Distribution Solutions segment. Financial results for our business acquisitions have been included in our consolidated financial statements since their respective acquisition dates. Purchase prices for our business acquisitions have been allocated based on estimated fair values at the date of acquisition. Goodwill recognized for our business acquisitions is generally not expected to be deductible for tax purposes. However, if we acquire the assets of a company, the goodwill may be deductible for tax purposes.

3. Redeemable Noncontrolling Interests

On May 22, 2014, Celesio and McKesson, through its wholly-owned subsidiary, Celesio Holdings Deutschland GmbH & Co. KGaA ("Celesio Deutschland," formerly known as "McKesson Deutschland GmbH & Co. KGaA"), entered into the domination and profit and loss transfer agreement (the "Domination Agreement"). The Domination Agreement was approved at the general shareholders' meeting of Celesio on July 15, 2014, approved by the Stuttgart Higher Regional Court for registration on December 2, 2014, and was registered in the commercial register of Celesio at the local court of Stuttgart on December 2, 2014.

Under the Domination Agreement, McKesson is obligated to pay an annual recurring compensation amount of €0.83 per Celesio share ("Compensation Amount"). The Compensation Amount is recognized ratably during the applicable annual period and is included in our condensed consolidated statements of operations within the caption, "Net Income Attributable to Noncontrolling Interests," and the corresponding liability balance is included within "Other accrued liabilities" on our condensed consolidated balance sheet.

In addition, under the Domination Agreement, the noncontrolling interests in Celesio are redeemable at the option of the holder as a result of a right to put their Celesio shares at €22.99 per share ("Put Right"). Accordingly, the noncontrolling interests in Celesio are presented as "Redeemable Noncontrolling Interests" on our condensed consolidated balance sheet. The Put Right amount is increased annually for interest in the amount of five percentage points above a base rate published by the German Bundesbank semiannually, less the guaranteed dividend payment for calendar year 2014 ("Guaranteed Dividend") and any Compensation Amount already paid in respect of the relevant time period ("Put Amount"). The exercise of the Put Right will reduce the balance of redeemable noncontrolling interests. There were no material exercises during the first quarter of 2016. The balance of redeemable noncontrolling interests is reported at the greater of its carrying value or its maximum redemption value at each reporting date. The redemption value is the Put Amount adjusted for exchange rate fluctuations each period. At June 30, 2015 and March 31, 2015, the carrying value of redeemable noncontrolling interests of $1.43 billion and $1.39 billion exceeded the maximum redemption value of $1.26 billion and $1.21 billion. At June 30, 2015 and March 31, 2015, we owned approximately 76.0% of Celesio's outstanding common shares.

Subsequent to the Domination Agreement's registration, certain noncontrolling shareholders of Celesio initiated appraisal proceedings ("Appraisal Proceedings") with the Stuttgart Higher Regional Court to