BROWN FORMAN CORP
Form 10-Q
December 06, 2018
United States
Securities and Exchange Commission
Washington, D.C. 20549

FORM 10-Q
(Mark One)

þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended October 31, 2018
OR
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 No. 001-00123

Brown-Forman Corporation
(Exact name of Registrant as specified in its Charter)

Delaware	61-0143150
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

850 Dixie Highway	
Louisville, Kentucky	40210
(Address of principal executive offices)	(Zip Code)

(502) 585-1100
(Registrant’s telephone number, including area code)
N/A
(Former name, former address and former fiscal year, if changed since last report)
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 þ No o
Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes þ No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer	þ	Accelerated filer	¨
Non-accelerated filer	¨	Smaller reporting company	¨
		Emerging growth company	¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date: November 30, 2018

Class A Common Stock ($.15 par value, voting)	169,010,917
Class B Common Stock ($.15 par value, nonvoting)	307,948,847

BROWN-FORMAN CORPORATION
Index to Quarterly Report Form 10-Q

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

BROWN-FORMAN CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(Dollars in millions, except per share amounts)

	Three Months Ended October 31,		Six Months Ended October 31,	
	2017	2018	2017	2018
Sales	$1,166	$1,161	$2,095	$2,148
Excise taxes	252	251	458	472
Net sales	914	910	1,637	1,676
Cost of sales	304	320	534	563
Gross profit	610	590	1,103	1,113
Advertising expenses	109	102	196	200
Selling, general, and administrative expenses	162	161	323	329
Other expense (income), net	(10)	(5)	(11)	(12)
Operating income	349	332	595	596
Non-operating postretirement expense	3	2	5	4
Interest income	(1)	(2)	(2)	(4)
Interest expense	16	22	32	44
Income before income taxes	331	310	560	552
Income taxes	92	61	143	103
Net income	$239	$249	$417	$449
Earnings per share:				
Basic	$0.50	$0.52	$0.87	$0.93
Diluted	$0.49	$0.52	$0.86	$0.93

See notes to the condensed consolidated financial statements.

BROWN-FORMAN CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)
(Dollars in millions)

	Three Months Ended October 31,		Six Months Ended October 31,	
	2017	2018	2017	2018
Net income	$239	$249	$417	$449
Other comprehensive income (loss), net of tax:				
Currency translation adjustments	(25)	(27)	9	(39)
Cash flow hedge adjustments	7	22	(16)	45
Postretirement benefits adjustments	3	4	6	7
Net other comprehensive income (loss)	(15)	(1)	(1)	13
Comprehensive income	$224	248	$416	$462

See notes to the condensed consolidated financial statements.

BROWN-FORMAN CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
(Dollars in millions)

	April 30, 2018	October 31, 2018
Assets		
Cash and cash equivalents	$ 239	$ 193
Accounts receivable, less allowance for doubtful accounts of $7 at April 30 and October 31	639	768
Inventories:		
Barreled whiskey	947	937
Finished goods	225	303
Work in process	117	145
Raw materials and supplies	90	92
Total inventories	1,379	1,477
Other current assets	298	305
Total current assets	2,555	2,743
Property, plant and equipment, net	780	785
Goodwill	763	750
Other intangible assets	670	648
Deferred tax assets	16	16
Other assets	192	207
Total assets	$ 4,976	$ 5,149
Liabilities		
Accounts payable and accrued expenses	$ 581	$ 620
Accrued income taxes	25	17
Short-term borrowings	215	258
Total current liabilities	821	895
Long-term debt	2,341	2,288
Deferred tax liabilities	85	113
Accrued pension and other postretirement benefits	191	193
Other liabilities	222	163
Total liabilities	3,660	3,652
Commitments and contingencies		
Stockholders' Equity		
Common stock:		
Class A, voting, $0.15 par value (170,000,000 shares authorized; 170,000,000 shares issued)	25	25
Class B, nonvoting, $0.15 par value (400,000,000 shares authorized; 314,532,000 shares issued)	47	47
Additional paid-in capital	4	4
Retained earnings	1,730	2,016
Accumulated other comprehensive income (loss), net of tax	(378)	(365)
Treasury stock, at cost (3,531,000 and 5,932,000 shares at April 30 and October 31, respectively)	(112)	(230)
Total stockholders' equity	1,316	1,497
Total liabilities and stockholders' equity	$ 4,976	$ 5,149

See notes to the condensed consolidated financial statements.

BROWN-FORMAN CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(Dollars in millions)

	Six Months Ended October 31,	
	2017	2018
Cash flows from operating activities:		
Net income	$417	$449
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	31	36
Stock-based compensation expense	9	9
Deferred income taxes	(10)	4
Changes in assets and liabilities	(229)	(226)
Cash provided by operating activities	218	272
Cash flows from investing activities:		
Additions to property, plant, and equipment	(64)	(53)
Payments for corporate-owned life insurance	(4)	(2)
Computer software expenditures	(1)	(2)
Cash used for investing activities	(69)	(57)
Cash flows from financing activities:		
Net change in short-term borrowings	21	42
Net payments related to exercise of stock-based awards	(7)	(5)
Acquisition of treasury stock	(1)	(128)
Dividends paid	(140)	(152)
Cash used for financing activities	(127)	(243)
Effect of exchange rate changes on cash and cash equivalents	8	(18)
Net increase (decrease) in cash and cash equivalents	30	(46)
Cash and cash equivalents, beginning of period	182	239
Cash and cash equivalents, end of period	$212	$193

See notes to the condensed consolidated financial statements.

BROWN-FORMAN CORPORATION AND SUBSIDIARIES
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

In these notes, "we," "us," "our," "Brown-Forman," and the "Company" refer to Brown-Forman Corporation and its consolidat subsidiaries, collectively.

1. Condensed Consolidated Financial Statements

We prepared the accompanying unaudited condensed consolidated financial statements pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (SEC) for interim financial information. In accordance with those rules and regulations, we condensed or omitted certain information and disclosures normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP). In our opinion, the accompanying financial statements include all adjustments, consisting only of normal recurring adjustments (unless otherwise indicated), necessary for a fair statement of our financial results for the periods covered by this report. The results for interim periods are not necessarily indicative of future or annual results.

We suggest that you read these condensed financial statements together with the financial statements and footnotes included in our Annual Report on Form 10-K for the fiscal year ended April 30, 2018 (2018 Form 10-K). Except for adopting the new accounting standards discussed below, we prepared the accompanying financial statements on a basis that is substantially consistent with the accounting principles applied in our 2018 Form 10-K.

Recently adopted accounting standards. As of May 1, 2018, we adopted the following Accounting Standards Updates (ASUs) issued by the Financial Accounting Standards Board (FASB):

- ASU 2014-09: Revenue from Contracts with Customers. This update, codified along with various amendments as Accounting Standards Codification Topic 606 (ASC 606), replaces previous revenue recognition guidance. The core principle of ASC 606 requires an entity to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration that it expects to be entitled to in exchange for those goods or services. ASC 606 also requires more financial statement disclosures than were required by previous revenue recognition standards. We applied this new guidance on a modified retrospective basis through a cumulative-effect adjustment that reduced retained earnings as of May 1, 2018, by $25 million (net of tax). See Note 2 for additional information about our revenues and the impact of adopting ASC 606.
- ASU 2016-15: Classification of Certain Cash Receipts and Cash Payments. This new guidance addresses eight specific issues related to the classification of certain cash receipts and cash payments on the statement of cash flows. The impact of adopting the new guidance was limited to a change in our classification of cash payments for premiums on corporate-owned life insurance policies, which we previously reflected in operating activities. Under the new guidance, we classify those payments as investing activities. We retrospectively adjusted prior period cash flow statements to conform to the new classification. As a result, we reclassified payments of $4 million from operating activities to investing activities for the six months ended October 31, 2017.
- ASU 2016-16: Income Taxes: Intra-Entity Transfers of Assets Other Than Inventory. This revised guidance requires the recognition of the income tax consequences (expense or benefit) of an intercompany transfer of assets other than inventory when the transfer occurs. It maintains the existing requirement to defer the recognition of the income tax consequences of an intercompany transfer of inventory until the inventory is sold to an outside party. We applied the guidance on a modified retrospective basis through a cumulative-effect adjustment that increased retained earnings as of May 1, 2018, by $20 million.
- ASU 2017-04: Simplifying the Test for Goodwill Impairment. This updated guidance eliminates the second step of the previous two-step quantitative test of goodwill for impairment. Under the new guidance, the quantitative test consists of a single step in which the carrying amount of the reporting unit is compared to its fair value. An impairment charge would be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the amount of the impairment would be limited to the total amount of goodwill allocated to the

reporting unit. The guidance does not affect the existing option to perform the qualitative assessment for a reporting unit to determine whether the quantitative impairment test is necessary. The prospective adoption of the new standard had no impact on our consolidated financial statements.

- ASU 2017-07: Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost. This new guidance addresses the presentation of the net periodic cost (NPC) associated with pension and other postretirement benefit plans. The guidance requires the service cost component of the NPC to be reported in the income statement in the same line item(s) as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of the NPC are to be presented separately from the service cost and outside of income from operations. In addition, the guidance allows only the service cost component of NPC to be eligible for capitalization when applicable. We applied the guidance retrospectively for the presentation in the income statement and prospectively for the capitalization of service cost. The retrospective application increased previously-reported operating income by $3 million and $5 million for the three and six months ended October 31, 2017, respectively. As the retrospective application merely reclassified amounts from operating income to non-operating expense, there was no effect on previously-reported net income or earnings per share.

New accounting standards to be adopted. The FASB has issued the ASUs described below that we are not required to adopt until May 1, 2019 (although early adoption is permitted). We are currently evaluating their potential impact on our consolidated financial statements.

- ASU 2016-02: Leases. This update, codified along with various amendments as Accounting Standards Codification Topic 842 (ASC 842), replaces existing lease accounting guidance. Under ASC 842, a lessee should recognize on its balance sheet a liability to make lease payments and a right-of-use asset representing its right to use the underlying asset for the lease term. ASC 842 permits an entity to make an accounting policy election not to recognize lease assets and liabilities for leases with a term of 12 months or less. It also requires additional quantitative and qualitative disclosures about leasing arrangements.

We are continuing to assess the potential impact on our financial statements of adopting ASC 842. As we progress in our assessment, we are identifying and preparing to make any changes to our accounting policies and practices, systems, processes, and controls that may be required to implement the new standard. Although we are unable to quantify the impact of adoption at this time, the amount of lease liabilities and right-of-use assets to be recognized on our balance sheet could be material. We do not currently expect adoption to have a material impact on our results of operations, stockholders' equity, or cash flows.

We will adopt ASC 842 as of May 1, 2019, using a modified retrospective transition approach for leases existing at that date. For the transition, we expect to elect to use the package of practical expedients to not reassess (a) whether existing contracts are or contain leases, (b) the classification of existing leases, and (c) initial direct costs for existing leases.

- ASU 2017-12: Targeted Improvements to Accounting for Hedging Activities. This new guidance is intended to better align hedge accounting with an entity's risk management activities and improve disclosures about hedges. The guidance expands hedge accounting for financial and nonfinancial risk components, eliminates the requirement to separately measure and report hedge ineffectiveness, simplifies the way assessments of hedge effectiveness may be performed, and amends some presentation and disclosure requirements for hedges. It is to be applied using a modified retrospective transition approach for cash flow and net investment hedges existing at the date of adoption. The amended presentation and disclosure guidance is required only prospectively. We have not yet determined our plans for adoption, but currently do not expect to adopt this new guidance before the required adoption date.
- ASU 2018-02: Reclassification of Certain Effects from Accumulated Other Comprehensive Income. This new guidance would allow a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act enacted by the U.S. government in December 2017. It is to be applied either in the period of adoption or retrospectively to each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act is recognized. We have not yet determined our plans for adoption, but currently do not expect to adopt this new guidance before the required adoption date.

There are no other new accounting standards to be adopted that we currently believe might have a significant impact on our consolidated financial statements.

Reclassifications. We have reclassified some previously reported expense amounts related to certain marketing research and promotional agency costs to conform to the current year classification. These immaterial reclassifications between advertising expenses and selling, general, and administrative expenses had no impact on net income.

2. Net Sales

Effective May 1, 2018, we updated our policy for recognizing revenue (“net sales”) to reflect the adoption of ASC 606. We describe the updated policy below. Also, we show how the adoption impacted our financial statements and we present disaggregated net sales information in accordance with the new standard.

Revenue recognition policy. Our net sales predominantly reflect global sales of beverage alcohol consumer products. We sell these products under contracts with different types of customers, depending on the market. The customer is most often a distributor, wholesaler, or retailer.

Each contract typically includes a single performance obligation to transfer control of the products to the customer. Depending on the contract, control is transferred when the products are either shipped or delivered to the customer, at which point we recognize the transaction price for those products as net sales. The transaction price recognized at that point reflects our estimate of the consideration to be received in exchange for the products. The actual amount may ultimately differ due to the effect of various customer incentives and trade promotion activities. In making our estimates, we consider our historical experience and current expectations, as applicable. Adjustments recognized during the three and six months ended October 31, 2018, for changes in estimated transaction prices of products sold in prior periods were not material.

Net sales exclude taxes we collect from customers that are imposed by various governments on our sales, and are reduced by payments to customers unless made in exchange for distinct goods or services with fair values approximating the payments.

Net sales include any amounts we bill customers for shipping and handling activities related to the products. We recognize the cost of those activities in cost of sales during the same period in which we recognize the related net sales.

Sales returns, which are permitted only in limited situations, are not material.

Customer payment terms generally range from 30 to 90 days. There are no significant amounts of contract assets or liabilities.

Impact of adoption. We adopted ASC 606 using the modified retrospective method. As a result, we recorded an adjustment that decreased retained earnings as of May 1, 2018, by $25 million (net of tax). The adjustment reflects the cumulative effect on that date of applying our updated revenue recognition policy, under which we recognize the cost of certain customer incentives earlier than we did before adopting ASC 606. Although we do not expect this change in timing to have a significant impact on a full-year basis, we do anticipate some change in the pattern of recognition among fiscal quarters. Additionally, some payments to customers that we classified as expenses before adopting the new standard are classified as reductions of net sales under our new policy.

The following table shows how the adoption of ASC 606 impacted our consolidated statement of operations for the three months ended October 31, 2018:

	Three Months Ended October 31, 2018		
(Dollars in millions, except per share amounts)	Under Prior Guidance	As Reported Under ASC 606	Effect of Adoption
Sales	$1,169	$1,161	$(8)
Excise taxes	251	251	—
Net sales	918	910	(8)
Cost of sales	320	320	—
Gross profit	598	590	(8)
Advertising expenses	107	102	(5)
Selling, general, and administrative expenses	162	161	(1)
Other expense (income), net	(5)	(5)	—
Operating income	334	332	(2)
Non-operating postretirement expense	2	2	—
Interest income	(2)	(2)	—
Interest expense	22	22	—
Income before income taxes	312	310	(2)
Income taxes	61	61	—
Net income	$251	$249	$(2)
Earnings per share:			
Basic	$0.52	$0.52	$—
Diluted	$0.52	$0.52	$—

The following table shows how the adoption of ASC 606 impacted our consolidated statement of operations for the six months ended October 31, 2018:

	Six Months Ended October 31, 2018		
(Dollars in millions, except per share amounts)	Under Prior Guidance	As Reported Under ASC 606	Effect of Adoption
Sales	$2,166	$2,148	$(18)
Excise taxes	472	472	—
Net sales	1,694	1,676	(18)
Cost of sales	563	563	—
Gross profit	1,131	1,113	(18)
Advertising expenses	208	200	(8)
Selling, general, and administrative expenses	331	329	(2)
Other expense (income), net	(12)	(12)	—
Operating income	604	596	(8)
Non-operating postretirement expense	4	4	—
Interest income	(4)	(4)	—
Interest expense	44	44	—
Income before income taxes	560	552	(8)
Income taxes	105	103	(2)
Net income	$455	$449	$(6)

Earnings per share:			
Basic	$0.94	$ 0.93	$ (0.01)
Diluted	$0.94	$ 0.93	$ (0.01)

10

The following table shows how the adoption of ASC 606 impacted our consolidated balance sheet as of October 31, 2018:

	As of October 31, 2018		
(Dollars in millions)	Under Prior Guidance	As Reported Under ASC 606	Effect of Adoption
Assets			
Other current assets	$306	$ 305	$ (1)
Deferred tax assets	15	16	1
Total assets	5,149	5,149	—
Liabilities			
Accounts payable and accrued expenses	$580	$ 620	$ 40
Deferred tax liabilities	122	113	(9)
Total liabilities	3,621	3,652	31
Stockholders' Equity			
Retained earnings	$2,047	$ 2,016	$ (31)
Total stockholders' equity	1,528	1,497	(31)

Disaggregated revenues.

The following table shows our net sales by geography:

	Three Months Ended October 31,		Six Months Ended October 31,	
(Dollars in millions)	2017	2018	2017	2018
United States	$438	$447	$793	$804
Developed International[1]	248	234	441	449
Emerging[2]	159	164	282	295
Travel Retail[3]	44	38	74	76
Non-branded and bulk[4]	25	27	47	52
Total	$914	$910	$1,637	$1,676

[1]Represents net sales of branded products to "advanced economies" as defined by the International Monetary Fund (IMF), excluding the United States. Our largest developed international markets are the United Kingdom, Australia, and Germany.

[2]Represents net sales of branded products to "emerging and developing economies" as defined by the IMF. Our largest emerging markets are Mexico and Poland.

[3]Represents net sales of branded products to global duty-free customers, travel retail customers, and the U.S. military regardless of customer location.

[4]Includes net sales of used barrels, bulk whiskey and wine, and contract bottling regardless of customer location.

The following table shows our net sales by product category:

	Three Months Ended October 31,		Six Months Ended October 31,	
(Dollars in millions)	2017	2018	2017	2018
Whiskey[1]	$713	$706	$1,270	$