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

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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)

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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		Six Months Ended	
	October 31,		October 31,	
(Dollars in millions)	2017	2018	2017	2018
Whiskey[1]	$713	$706	$1,270	$1,308
Tequila[2]	64	70	122	132
Vodka[3]	35	34	66	60
Wine[4]	63	62	105	102
Rest of portfolio	14	11	27	22
Non-branded and bulk[5]	25	27	47	52
Total	$914	$910	$1,637	$1,676

[1]Includes all whiskey spirits and whiskey-based flavored liqueurs, ready-to-drink, and ready-to-pour products. The brands included in this category are the Jack Daniel's family of brands, Woodford Reserve, Canadian Mist, GlenDronach, BenRiach, Glenglassaugh, Old Forester, Early Times, Slane Irish Whiskey, and Coopers' Craft.
[2]Includes el Jimador, Herradura, New Mix, Pepe Lopez, and Antiguo.
[3]Includes Finlandia.
[4]Includes Korbel Champagne and Sonoma-Cutrer wines.
[5]Includes net sales of used barrels, bulk whiskey and wine, and contract bottling regardless of customer location.

3. Income Taxes

Our consolidated interim effective tax rate is based upon our expected annual operating income, statutory tax rates, and income tax laws in the various jurisdictions in which we operate. Significant or unusual items, including adjustments to accruals for tax uncertainties, are recognized in the fiscal quarter in which the related event or a change in judgment occurs. The effective tax rate of 18.6% for the six months ended October 31, 2018, is lower than the expected tax rate of 21.4% on ordinary income for the full fiscal year, primarily due to (a) the impact of discrete items, including true-ups to prior year tax returns, (b) the impact of the current year net adjustment to the provisional repatriation U.S. tax charge that was made during fiscal 2018 (discussed below), and (c) the excess tax benefits related to stock-based compensation. Our expected tax rate includes current fiscal year additions for existing tax contingency items.

On December 22, 2017, the U.S. government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (Tax Act). The Tax Act significantly revised the future ongoing U.S. corporate income tax by, among other things, lowering U.S. corporate income tax rates and implementing a territorial tax system. As we have an April 30 fiscal year-end, the lower corporate income tax rate was phased in, resulting in a U.S. statutory federal rate of 30.4% for our fiscal year ended April 30, 2018, and 21% for our current and subsequent fiscal years. For the six months ended October 31, 2018, the impact of reducing the U.S. statutory federal rate from 35% (the pre-Tax Act rate) to 21% resulted in a tax benefit of approximately $60 million.

There are also certain transitional impacts of the Tax Act. As part of the transition to the new territorial tax system, the Tax Act imposed a one-time repatriation tax on deemed repatriation of historical earnings of foreign subsidiaries. In addition, the reduction of the U.S. corporate tax rate caused us to adjust our U.S. deferred tax assets and liabilities to the lower federal base rate of 21%. These transitional impacts resulted in a provisional net charge of $43 million for the year ended April 30, 2018, comprised of a provisional repatriation U.S. tax charge of $91 million and a provisional net deferred tax benefit of $48 million. In the six months ended October 31, 2018, we recorded a benefit of $4 million as an adjustment to the provisional repatriation tax.

Historically, we have asserted that the undistributed earnings of our foreign subsidiaries are reinvested indefinitely outside the United States. Therefore, no income taxes have been provided for any outside basis differences inherent in these subsidiaries other than those subject to the one-time repatriation tax. As of October 31, 2018, we changed our indefinite reinvestment assertion with respect to current year earnings and prior year undistributed earnings for one of those foreign subsidiaries (but not for its other outside basis differences). We intend to repatriate approximately $120 million of cash to the United States from this subsidiary during the fiscal quarter ending January 31, 2019. No incremental taxes are due on this distribution of cash beyond the repatriation tax recorded in fiscal year 2018. We have not changed the indefinite reinvestment assertion for undistributed earnings or other outside basis differences for any of the other foreign subsidiaries. We will continue to evaluate our future cash deployment and may change our indefinite reinvestment assertion in future periods.

The Tax Act also established new tax laws that impact our financial statements beginning in the current fiscal year. These new laws include, but are not limited to (a) Global Intangible Low-Tax Income (GILTI), a new provision for tax on low-tax foreign earnings; (b) Base Erosion Anti-abuse Tax (BEAT), a new minimum tax; (c) Foreign-Derived Intangible Income (FDII), a new provision for deductions related to foreign-derived intangibles; (d) repeal of the domestic production activity deduction; and (e) limitations on certain executive compensation. For the six months ended October 31, 2018, the net impact of these provisions was approximately $7 million of additional tax.

As noted, certain income earned by foreign subsidiaries must be included in U.S. taxable income under the GILTI provisions. The FASB allows an accounting policy election of either recognizing deferred taxes for temporary differences expected to reverse as GILTI in future years or recognizing such taxes as a current period expense when incurred. We have elected to recognize these taxes as a current period expense when incurred.

The changes included in the Tax Act are broad and complex. The final transition impacts of the Tax Act may differ from the current estimates, due to, among other things, changes in interpretations of the Tax Act, any legislative action to address questions that arise because of the Tax Act, any changes in accounting standards for income taxes or related interpretations in response to the Tax Act, or any updates or changes to estimates we have used to calculate the transition impacts, including impacts from changes to current year earnings estimates and foreign currency exchange rates. The SEC has issued rules that allow for a measurement period of up to one year after the enactment date of the Tax Act to finalize the recording of the related tax impacts. As of October 31, 2018, the amounts recorded for the Tax Act remain provisional for the one-time repatriation tax and the adjustment to our U.S. deferred tax assets and liabilities. We will finalize and record any additional adjustments within the allowed measurement period.

4. Earnings Per Share

We calculate basic earnings per share by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share further includes the dilutive effect of stock-based compensation awards. We calculate that dilutive effect using the “treasury stock method” (as defined by GAAP).

The following table presents information concerning basic and diluted earnings per share:

	Three Months Ended October 31,		Six Months Ended October 31,	
(Dollars in millions, except per share amounts)	2017	2018	2017	2018
Net income available to common stockholders	$239	$ 249	$417	$ 449
Share data (in thousands):				
Basic average common shares outstanding	480,150	480,436	480,095	480,647
Dilutive effect of stock-based awards	3,134	3,155	3,035	3,316
Diluted average common shares outstanding	483,284	483,591	483,130	483,963
Basic earnings per share	$0.50	$ 0.52	$0.87	$ 0.93
Diluted earnings per share	$0.49	$ 0.52	$0.86	$ 0.93

We excluded common stock-based awards for approximately 1,501,000 shares and 347,000 shares from the calculation of diluted earnings per share for the three months ended October 31, 2017 and 2018, respectively. We excluded common stock-based awards for approximately 1,610,000 shares and 595,000 shares from the calculation of diluted earnings per share for the six months ended October 31, 2017 and 2018, respectively. We excluded those awards because they were not dilutive for those periods under the treasury stock method.

5. Inventories

Inventories are valued at the lower of cost or market. Some of our consolidated inventories are valued using the last-in, first-out (LIFO) method, which we use for the majority of our U.S. inventories. If the LIFO method had not been used, inventories at current cost would have been $290 million higher than reported as of April 30, 2018, and $298 million higher than reported as of October 31, 2018. Changes in the LIFO valuation reserve for interim periods are based on a proportionate allocation of the estimated change for the entire fiscal year.

6. Goodwill and Other Intangible Assets

The following table shows the changes in goodwill (which includes no accumulated impairment losses) and other intangible assets during the six months ended October 31, 2018:

(Dollars in millions)	Goodwill	Other Intangible Assets
Balance at April 30, 2018	$ 763	$ 670
Foreign currency translation adjustment	(13)	(22)
Balance at October 31, 2018	$ 750	$ 648

Our other intangible assets consist of trademarks and brand names, all with indefinite useful lives.

7. Commitments and Contingencies

We operate in a litigious environment, and we are sued in the normal course of business. Sometimes plaintiffs seek substantial damages. Significant judgment is required in predicting the outcome of these suits and claims, many of which take years to adjudicate. We accrue estimated costs for a contingency when we believe that a loss is probable and we can make a reasonable estimate of the loss, and then adjust the accrual as appropriate to reflect changes in facts and circumstances. We do not believe it is reasonably possible that these existing loss contingencies, individually or in the aggregate, would have a material adverse effect on our financial position, results of operations, or liquidity. No material accrued loss contingencies are recorded as of October 31, 2018.

We have guaranteed the repayment by a third-party importer of its obligation under a bank credit facility that it uses in connection with its importation of our products in Russia. If the importer were to default on that obligation, which we believe is unlikely, our maximum possible exposure under the existing terms of the guaranty would be approximately $10 million (subject to changes in foreign currency exchange rates). Both the fair value and carrying amount of the guaranty are insignificant.

As of October 31, 2018, our actual exposure under the guaranty of the importer’s obligation is approximately $7 million. We also have accounts receivable from that importer of approximately $11 million at October 31, 2018, which we expect to collect in full.

Based on the financial support we provide to the importer, we believe it meets the definition of a variable interest entity. However, because we do not control this entity, it is not included in our consolidated financial statements.

8. Debt

Our long-term debt (net of unamortized discount and issuance costs) consists of:

(Principal and carrying amounts in millions)	April 30, 2018	October 31, 2018
2.25% senior notes, $250 principal amount, due January 15, 2023	$ 248	$ 248
3.50% senior notes, $300 principal amount, due April 15, 2025	296	296
1.20% senior notes, €300 principal amount, due July 7, 2026	361	338
2.60% senior notes, £300 principal amount, due July 7, 2028	408	377
4.00% senior notes, $300 principal amount, due April 15, 2038	293	293
3.75% senior notes, $250 principal amount, due January 15, 2043	248	248
4.50% senior notes, $500 principal amount, due July 15, 2045	487	488
	$ 2,341	$ 2,288

As of April 30, 2018, our short-term borrowings consisted of $215 million of commercial paper, with an average interest rate of 2.04%, and an average remaining maturity of 23 days. As of October 31, 2018, our short-term borrowings of $258 million included $257 million of commercial paper, with an average interest rate of 2.37%, and an average remaining maturity of 21 days.

9. Fair Value Measurements

The following table summarizes the assets and liabilities measured or disclosed at fair value on a recurring basis:

	April 30, 2018		October 31, 2018	
(Dollars in millions)	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Assets				
Cash and cash equivalents	$239	$239	$193	$193
Currency derivatives	1	1	31	31
Liabilities				
Currency derivatives	39	39	6	6
Short-term borrowings	215	215	258	258
Long-term debt	2,341	2,386	2,288	2,294

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date. We categorize the fair values of assets and liabilities into three levels based upon the assumptions (inputs) used to determine those values. Level 1 provides the most reliable measure of fair value, while Level 3 generally requires significant management judgment. The three levels are:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2 – Observable inputs other than those included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in inactive markets; or other inputs that are observable or can be derived from or corroborated by observable market data.
- Level 3 – Unobservable inputs supported by little or no market activity.

We determine the fair values of our currency derivatives (forward contracts) using standard valuation models. The significant inputs used in these models, which are readily available in public markets or can be derived from observable market transactions, include the applicable spot rates, forward rates, and discount rates. The discount rates are based on the historical U.S. Treasury rates. These fair value measurements are categorized as Level 2 within the valuation hierarchy.

We determine the fair value of long-term debt primarily based on the prices at which similar debt has recently traded in the market and also considering the overall market conditions on the date of valuation. These fair value measurements are categorized as Level 2 within the valuation hierarchy.

The fair values of cash, cash equivalents, and short-term borrowings approximate the carrying amounts due to the short maturities of these instruments.

We measure some assets and liabilities at fair value on a nonrecurring basis. That is, we do not measure them at fair value on an ongoing basis, but we do adjust them to fair value in some circumstances (for example, when we determine that an asset is impaired). No material nonrecurring fair value measurements were required during the periods presented in these financial statements.

10. Derivative Financial Instruments and Hedging Activities

Our multinational business exposes us to global market risks, including the effect of fluctuations in currency exchange rates, commodity prices, and interest rates. We use derivatives to help manage financial exposures that occur in the normal course of business. We formally document the purpose of each derivative contract, which includes linking the contract to the financial exposure it is designed to mitigate. We do not hold or issue derivatives for trading or speculative purposes.

We use currency derivative contracts to limit our exposure to the currency exchange risk that we cannot mitigate internally by using netting strategies. We designate most of these contracts as cash flow hedges of forecasted transactions (expected to occur within three years). We record all changes in the fair value of cash flow hedges (except any ineffective portion) in accumulated other comprehensive income (AOCI) until the underlying hedged transaction occurs, at which time we reclassify that amount into earnings. We assess the effectiveness of these hedges based on changes in forward exchange rates. The ineffective portion of the changes in fair value of our hedges (recognized immediately in earnings) during the periods presented in this report was not material.

We had outstanding currency derivatives, related primarily to our euro, British pound, and Australian dollar exposures, with notional amounts totaling $1,098 million at April 30, 2018 and $1,255 million at October 31, 2018.

We also use foreign currency-denominated debt to help manage our currency exchange risk. As of October 31, 2018, $615 million of our foreign currency-denominated debt instruments were designated as net investment hedges. These net investment hedges are intended to mitigate foreign exchange exposure related to non-U.S. dollar net investments in certain foreign subsidiaries. Any change in value of the designated portion of the hedging instruments is recorded in AOCI, offsetting the foreign currency translation adjustment of the related net investments that is also recorded in AOCI. There was no ineffectiveness related to our net investment hedges in any of the periods presented.

We do not designate some of our currency derivatives and foreign currency-denominated debt as hedges because we use them to at least partially offset the immediate earnings impact of changes in foreign exchange rates on existing assets or liabilities. We immediately recognize the change in fair value of these instruments in earnings.

We use forward purchase contracts with suppliers to protect against corn price volatility. We expect to physically take delivery of the corn underlying each contract and use it for production over a reasonable period of time. Accordingly, we account for these contracts as normal purchases rather than as derivative instruments.

The following tables present the pre-tax impact that changes in the fair value of our derivative instruments and non-derivative hedging instruments had on AOCI and earnings:

(Dollars in millions)	Classification	Three Months Ended October 31, 2017	2018
Derivative Instruments			
Currency derivatives designated as cash flow hedges:			
Net gain (loss) recognized in AOCI	n/a	$7	$30
Net gain (loss) reclassified from AOCI into earnings	Sales	(5)	—
Currency derivatives not designated as hedging instruments:			
Net gain (loss) recognized in earnings	Sales	1	3
Net gain (loss) recognized in earnings	Other income	(4)	(4)
Non-Derivative Hedging Instruments			
Foreign currency-denominated debt designated as net investment hedge:			
Net gain (loss) recognized in AOCI	n/a	1	19
Foreign currency-denominated debt not designated as hedging instrument:			
Net gain (loss) recognized in earnings	Other income	1	3

(Dollars in millions)	Classification	Six Months Ended October 31, 2017	2018
Derivative Instruments			
Currency derivatives designated as cash flow hedges:			
Net gain (loss) recognized in AOCI	n/a	$(29)	$57
Net gain (loss) reclassified from AOCI into earnings	Sales	(3)	(2)
Currency derivatives not designated as hedging instruments:			
Net gain (loss) recognized in earnings	Sales	(2)	6
Net gain (loss) recognized in earnings	Other income	5	(1)
Non-Derivative Hedging Instruments			
Foreign currency-denominated debt designated as net investment hedge:			
Net gain (loss) recognized in AOCI	n/a	(15)	47
Foreign currency-denominated debt not designated as hedging instrument:			
Net gain (loss) recognized in earnings	Other income	(15)	8

We expect to reclassify $13 million of deferred net gains on cash flow hedges recorded in AOCI as of October 31, 2018, to earnings during the next 12 months. This reclassification would offset the anticipated earnings impact of the underlying hedged exposures. The actual amounts that we ultimately reclassify to earnings will depend on the exchange rates in effect when the underlying hedged transactions occur. As of October 31, 2018, the maximum term of our outstanding derivative contracts was 36 months.

The following table presents the fair values of our derivative instruments:

(Dollars in millions)	Classification	Fair value of derivatives in a gain position	Fair value of derivatives in a loss position
April 30, 2018			
Designated as cash flow hedges:			
Currency derivatives	Other current assets	$ 2	$ (2)
Currency derivatives	Other assets	1	—
Currency derivatives	Accrued expenses	4	(23)
Currency derivatives	Other liabilities	2	(18)
Not designated as hedges:			
Currency derivatives	Accrued expenses	1	(5)
October 31, 2018			
Designated as cash flow hedges:			
Currency derivatives	Other current assets	18	(3)
Currency derivatives	Other assets	18	(2)
Currency derivatives	Accrued expenses	1	(3)
Currency derivatives	Other liabilities	—	—
Not designated as hedges:			
Currency derivatives	Accrued expenses	—	(4)

The fair values reflected in the above table are presented on a gross basis. However, as discussed further below, the fair values of those instruments subject to net settlement agreements are presented on a net basis in our balance sheets.

In our statement of cash flows, we classify cash flows related to cash flow hedges in the same category as the cash flows from the hedged items.

Credit risk. We are exposed to credit-related losses if the counterparties to our derivative contracts default. This credit risk is limited to the fair value of the contracts. To manage this risk, we contract only with major financial institutions that have earned investment-grade credit ratings and with whom we have standard International Swaps and Derivatives Association (ISDA) agreements that allow for net settlement of the derivative contracts. Also, we have established counterparty credit guidelines that are regularly monitored, and we monetize contracts when we believe it is warranted. Because of these safeguards, we believe we have no derivative positions that warrant credit valuation adjustments.

Some of our derivative instruments require us to maintain a specific level of creditworthiness, which we have maintained. If our creditworthiness were to fall below that level, then the counterparties to our derivative instruments could request immediate payment or collateralization for derivative instruments in net liability positions. The aggregate fair value of all derivatives with creditworthiness requirements that were in a net liability position was $38 million at April 30, 2018 and $6 million at October 31, 2018.

Offsetting. As noted above, our derivative contracts are governed by ISDA agreements that allow for net settlement of derivative contracts with the same counterparty. It is our policy to present the fair values of current derivatives (i.e., those with a remaining term of 12 months or less) with the same counterparty on a net basis in the balance sheet. Similarly, we present the fair values of noncurrent derivatives with the same counterparty on a net basis. Current derivatives are not netted with noncurrent derivatives in the balance sheet.

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The following table summarizes the gross and net amounts of our derivative contracts:

(Dollars in millions)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Balance Sheet	Net Amounts Presented in Balance Sheet	Gross Amounts Not Offset in Balance Sheet	Net Amounts
April 30, 2018					
Derivative assets	$ 10	$ (9)	$ 1	$ (1)	$ —
Derivative liabilities	(48)	9	(39)	1	(38)
October 31, 2018					
Derivative assets	37	(6)	31	—	31
Derivative liabilities	(12)	6	(6)	—	(6)

No cash collateral was received or pledged related to our derivative contracts as of April 30, 2018 or October 31, 2018.

11. Pension and Other Postretirement Benefits

The following table shows the components of the net cost of pension and other postretirement benefits recognized for our U.S. benefit plans. Information about similar international plans is not presented due to immateriality.

	Three Months Ended October 31,		Six Months Ended October 31,	
(Dollars in millions)	2017	2018	2017	2018
Pension Benefits:				
Service cost	$6	$ 6	$12	$12
Interest cost	7	9	15	17
Expected return on plan assets	(10)	(12)	(21)	(24)
Amortization of:				
Prior service cost (credit)	—	—	—	1
Net actuarial loss	6	5	11	10
Net cost	$9	$ 8	$17	$16
Other Postretirement Benefits:				
Interest cost	$1	$ 1	$1	$1
Amortization of prior service cost (credit)	(1)	(1)	(1)	(1)
Net cost	$—	$ —	$—	$—

12. Stockholders' Equity

The following table shows the changes in stockholders' equity by quarter during the six months ended October 31, 2017:

(Dollars in millions)	Class A Common Stock	Class B Common Stock	Additional Paid-in Capital	Retained Earnings	AOCI	Treasury Stock	Total
Balance at April 30, 2017	$ 25	$ 43	$ 65	$ 4,470	$ (390)	$ (2,843)	$ 1,370
Retirement of treasury stock		(10)	(8)	(2,684)		2,702	—
Net income				178			178
Net other comprehensive income (loss)					14		14
Cash dividends				(140)			(140)
Acquisition of treasury stock						(1)	(1)
Stock-based compensation expense			4				4
Stock issued under compensation plans						9	9
Loss on issuance of treasury stock issued under compensation plans			(14)				(14)
Balance at July 31, 2017	25	33	47	1,824	(376)	(133)	1,420
Net income				239			239
Net other comprehensive income (loss)					(15)		(15)
Stock-based compensation expense			5				5
Stock issued under compensation plans						1	1
Loss on issuance of treasury stock issued under compensation plans			(3)				(3)
Balance at October 31, 2017	$ 25	$ 33	$ 49	$ 2,063	$ (391)	$ (132)	$ 1,647

The following table shows the changes in stockholders' equity by quarter during the six months ended October 31, 2018:

(Dollars in millions)	Class A Common Stock	Class B Common Stock	Additional Paid-in Capital	Retained Earnings	AOCI	Treasury Stock	Total
Balance at April 30, 2018	$ 25	$ 47	$ 4	$ 1,730	$ (378)	$ (112)	$ 1,316
Cumulative effect of changes in accounting standards (Note 1)				(5)			(5)
Net income				200			200
Net other comprehensive income (loss)					14		14
Cash dividends				(152)			(152)
Acquisition of treasury stock						(6)	(6)
Stock-based compensation expense			5				5
Stock issued under compensation plans						9	9
Loss on issuance of treasury stock issued under compensation plans			(7)	(6)			(13)
Balance at July 31, 2018	25	47	2	1,767	(364)	(109)	1,368
Net income							