

MCKESSON CORP
Form 10-Q
February 01, 2011

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2010

**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 No

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 No

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 Accelerated filer Non-accelerated filer Smaller reporting
company

(Do not check if a smaller reporting company)

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

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 December 31, 2010

Common stock, \$0.01 par value

254,260,037 shares

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

	Quarter Ended		Nine Months Ended	
	December 31,		December 31,	
	2010	2009	2010	2009
Revenues	\$ 28,247	\$ 28,272	\$ 83,231	\$ 82,059
Cost of Sales	26,786	26,817	79,012	77,966
Gross Profit	1,461	1,455	4,219	4,093
Operating Expenses	965	946	2,808	2,678
Litigation Charge (Credit)	189		213	(20)
Total Operating Expenses	1,154	946	3,021	2,658
Operating Income	307	509	1,198	1,435
Other Income, Net	7	25	19	39
Interest Expense	(53)	(47)	(140)	(142)
Income from Continuing Operations Before Income Taxes				
Income Tax Expense	(106)	(161)	(369)	(417)
Income from Continuing Operations	155	326	708	915
Discontinued Operation gain on sale, net of tax			72	
Net Income	\$ 155	\$ 326	\$ 780	\$ 915
Earnings Per Common Share Diluted				
Continuing operations	\$ 0.60	\$ 1.19	\$ 2.69	\$ 3.36
Discontinued operation gain on sale			0.27	
Total	\$ 0.60	\$ 1.19	\$ 2.96	\$ 3.36
Basic				
Continuing operations	\$ 0.61	\$ 1.21	\$ 2.73	\$ 3.41
Discontinued operation gain on sale			0.28	
Total	\$ 0.61	\$ 1.21	\$ 3.01	\$ 3.41
Dividends Declared Per Common Share	\$ 0.18	\$ 0.12	\$ 0.54	\$ 0.36
Weighted Average Common Shares Diluted	258	274	264	272

Basic	254	269	259	269
	<i>See Financial Notes</i>			
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McKESSON CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(In millions, except per share amounts)
(Unaudited)

	December 31, 2010	March 31, 2010
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 3,213	\$ 3,731
Receivables, net	8,647	8,075
Inventories, net	9,547	9,441
Prepaid expenses and other	286	257
Total	21,693	21,504
Property, Plant and Equipment, Net	934	851
Capitalized Software Held for Sale, Net	153	234
Goodwill	4,321	3,568
Intangible Assets, Net	1,596	551
Other Assets	1,699	1,481
Total Assets	\$ 30,396	\$ 28,189
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Drafts and accounts payable	\$ 13,581	\$ 13,255
Deferred revenue	1,357	1,218
Deferred tax liabilities	1,100	977
Current portion of long-term debt	1,757	3
Other accrued liabilities	1,890	1,559
Total	19,685	17,012
Long-Term Debt	2,305	2,293
Other Noncurrent Liabilities	1,326	1,352
Other Commitments and Contingent Liabilities (Note 13)		
Stockholders Equity		
Preferred stock, \$0.01 par value, 100 shares authorized, no shares issued or outstanding		
Common stock, \$0.01 par value		
Shares authorized: December 31, 2010 and March 31, 2010	800	
Shares issued: December 31, 2010	365	
Shares issued: December 31, 2010	365	
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Additional Paid-in Capital		5,153	4,756	
Retained Earnings		7,876	7,236	
Accumulated Other Comprehensive Income		51	6	
Other		2	(12)	
Treasury Shares, at Cost, December 31, 2010	111 and March 31, 2010	88	(6,006)	(4,458)
Total Stockholders' Equity		7,080	7,532	
Total Liabilities and Stockholders' Equity		\$ 30,396	\$ 28,189	

See Financial Notes

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

	Nine Months Ended December	
	2010	31, 2009
Operating Activities		
Net income	\$ 780	\$ 915
Discontinued operation gain on sale, net of tax	(72)	
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation and amortization	352	350
Asset impairment charge capitalized software held for sale	72	
Share-based compensation expense	99	83
Other non-cash items	58	66
Changes in operating assets and liabilities, net of effect of acquisitions:		
Receivables	(198)	(415)
Inventories	22	(205)
Drafts and accounts payable	52	1,131
Deferred revenue	82	57
Litigation charge (credit)	213	(20)
Deferred tax expense on litigation credit		116
Litigation settlement payments	(26)	(350)
Other	(96)	(3)
Net cash provided by operating activities	1,338	1,725
Investing Activities		
Property acquisitions	(157)	(137)
Capitalized software expenditures	(111)	(134)
Acquisitions of businesses, less cash and cash equivalents acquired	(292)	(18)
Proceeds from sale of business	109	
Other	(15)	86
Net cash used in investing activities	(466)	(203)
Financing Activities		
Common stock share repurchases, including shares surrendered for tax withholding	(1,548)	(322)
Common stock issuances	238	159
Common stock transactions other	61	26
Dividends paid	(126)	(98)
Other	(21)	(2)
Net cash used in financing activities	(1,396)	(237)
Effect of exchange rate changes on cash and cash equivalents	6	34

Net increase (decrease) in cash and cash equivalents	(518)	1,319
Cash and cash equivalents at beginning of period	3,731	2,109
Cash and cash equivalents at end of period	\$ 3,213	\$ 3,428
Non-cash item:		
Fair value of acquisition debt assumed	\$ (1,910)	\$

See Financial Notes

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**McKESSON CORPORATION
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. 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, these unaudited condensed consolidated financial statements include all adjustments necessary for a fair presentation of the Company s financial position as of December 31, 2010, the results of operations for the quarters and nine months ended December 31, 2010 and 2009 and cash flows for the nine months ended December 31, 2010 and 2009.

The results of operations for the quarter and nine months ended December 31, 2010 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, 2010 previously filed with the SEC on May 4, 2010 (2010 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

Accounting for Transfers of Financial Assets: On April 1, 2010, we adopted amended accounting guidance for transfers of financial assets, including securitization transactions, in which entities have continued exposure to risks related to transferred financial assets. This amendment changed the requirements for derecognizing financial assets and expanded the disclosure requirements for such transactions. As a result of the amended accounting guidance, from April 1, 2010 forward, accounts receivable transactions under our accounts receivable securitization facility are accounted for as secured borrowings rather than asset sales. Refer to Financial Note 9, Debt and Financing Activities, for additional information.

Consolidations: On April 1, 2010, we adopted amended accounting guidance for consolidation of Variable Interest Entities (VIEs). The new guidance eliminates the quantitative approach previously required for determining the primary beneficiary of a VIE and requires ongoing qualitative reassessments of whether an enterprise is the primary beneficiary, including ongoing assessments of control over such entities. The adoption of this amended guidance did not have a material effect on our condensed consolidated financial statements.

Financing Receivables: On October 1, 2010, we adopted amended accounting guidance which expands disclosures regarding the credit quality of an entity s receivables portfolio and its related allowance for credit losses. The adoption of the amended guidance did not have a material effect on our condensed consolidated financial statements. Additional disclosure requirements regarding activity during a reporting period will be adopted in the fourth quarter of 2011 and the adoption of these disclosure requirements is not expected to have a material effect on our condensed consolidated financial statements.

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McKESSON CORPORATION
FINANCIAL NOTES (CONTINUED)
(UNAUDITED)

Newly Issued Accounting Pronouncements

In October 2009, the Financial Accounting Standards Board (FASB) issued amended accounting guidance for multiple-deliverable revenue arrangements. The amended guidance affects the determination of when individual deliverables included in a multiple-element arrangement may be treated as separate units of accounting. In addition, the amended guidance modifies the manner in which the transaction consideration is allocated across separately identified deliverables, eliminates the use of the residual value method of allocating arrangement consideration and requires expanded disclosure. The amended guidance will become effective for us for multiple-element arrangements entered into or materially modified on or after April 1, 2011. We are currently evaluating the effect of the amended guidance on our condensed consolidated financial statements.

In October 2009, the FASB issued amended accounting guidance for certain revenue arrangements that include software elements. The guidance amends pre-existing software revenue recognition guidance by removing from its scope tangible products that contain both software and non-software components that function together to deliver the product s functionality. The amended guidance will become effective for us for revenue arrangements entered into or materially modified on or after April 1, 2011. We are currently evaluating the effect of the amended guidance on our condensed consolidated financial statements.

In April 2010, the FASB issued amended accounting guidance for vendors who apply the milestone method of revenue recognition to research and development arrangements. The amended guidance applies to arrangements with payments that are contingent upon achieving substantively uncertain future events or circumstances. The amended guidance is effective on a prospective basis for us for milestones achieved on or after April 1, 2011. We are currently evaluating the effect of the amended guidance on our condensed consolidated financial statements.

2. Business Combinations

On December 30, 2010, we acquired all of the outstanding shares of US Oncology Holdings, Inc. (US Oncology) of The Woodlands, Texas for approximately \$2.1 billion, consisting of cash consideration of \$0.2 billion, net of cash acquired, and the assumption of liabilities with a fair value of \$1.9 billion. As an integrated oncology company, US Oncology is affiliated with community-based oncologists, and works with patients, hospitals, payors and the medical industry across all phases of the cancer research and delivery continuum. The acquisition of US Oncology expands our existing specialty pharmaceutical distribution business and adds practice management services for oncologists. The cash paid at acquisition was funded from cash on hand. Refer to Financial Note 9, Debt and Financing Activities, for additional information on the assumption and funding of acquired debt.

The following table summarizes the preliminary fair values of the assets acquired and liabilities assumed as of the acquisition date, which are included in our condensed consolidated balance sheet at December 31, 2010. Due to the timing of the acquisition, all amounts are subject to change within the measurement period as our fair value assessments are finalized:

(In millions)

Current assets	\$ 546
Goodwill	774
Intangible assets	1,099
Other long-term assets	396
Current liabilities	(535)
Current portion of long-term debt	(1,751)
Other long-term liabilities	(270)
Other stockholders' equity	(15)
Net assets acquired, less cash and cash equivalents	\$ 244

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McKESSON CORPORATION
FINANCIAL NOTES (CONTINUED)
(UNAUDITED)

Approximately \$774 million of the purchase price allocation was assigned to goodwill, which primarily reflects the expected future benefits to be realized upon integrating the business. Included in the purchase price allocation are acquired identifiable intangibles of \$1.1 billion primarily representing service agreements and a trade name, the fair value of which was determined by using primarily Level 3 inputs, which are based on unobservable inputs and reflect our own assumptions. The estimated weighted average lives of the service agreements and trade name are 20 years. Financial results for US Oncology were not included in the results of operations for the third quarter and nine months ended December 31, 2010 as they were not material. These results will be included within our Distribution Solutions segment beginning in the fourth quarter of 2011. We incurred \$34 million of acquisition-related expenses in the third quarter of 2011 as follows: \$24 million recorded in operating expenses in Distribution Solutions segment and \$10 million of bridge loan fees recorded in interest expense.

During the last two years, we also completed a number of other smaller acquisitions within both of our operating segments. 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. Pro forma results of operations for our business acquisitions have not been presented because the effects were not material to the consolidated financial statements on either an individual or an aggregate basis.

3. Asset Impairment Charge Capitalized Software Held for Sale

Our capitalized software held for sale is amortized over three years. At each balance sheet date, or earlier if an indicator of an impairment exists, we evaluate the recoverability of unamortized capitalized software costs based on estimated future undiscounted revenues net of estimated related costs over the remaining amortization period. At the end of the second quarter of 2010, our Horizon Enterprise Revenue Management™ (HzERM) software product became generally available. In October 2010, we decreased our estimated revenues over the next 24 months for our HzERM software product and as a result, concluded that the estimated future revenues, net of estimated related costs, were insufficient to recover its carrying value. Accordingly, we recorded a \$72 million non-cash impairment charge at September 30, 2010 within our Technology Solutions segment's cost of sales to reduce the carrying value of the software product to its net realizable value.

4. Discontinued Operation

In July 2010, our Technology Solutions segment sold its wholly-owned subsidiary, McKesson Asia Pacific Pty Limited (MAP), a provider of phone and web-based healthcare services in Australia and New Zealand, for net sales proceeds of \$109 million. The divestiture generated a pre-tax and after-tax gain of \$95 million and \$72 million. As a result of the sale we were able to utilize capital loss carry-forwards for which we previously recorded a valuation allowance of \$15 million. The release of the valuation allowance is included as a tax benefit in our after-tax gain on the divestiture. The after-tax gain on disposition was recorded as a discontinued operation in our condensed statement of operations in the second quarter of 2011. Should we incur a capital gain within our continuing operations during the remainder of 2011, some portion or all of the \$15 million valuation allowance reversal could be reclassified to continuing operations. The historical financial operating results and net assets of MAP were not material to our condensed consolidated financial statements for all periods presented.

5. Share-Based Compensation

We provide share-based compensation for our employees, officers and non-employee directors, including stock options, an employee stock purchase plan, restricted stock units (RSUs) and performance-based restricted stock units (PeRSUs) (collectively, share-based awards).

Compensation expense for stock options is recognized on a straight-line basis over the requisite service period and is based on the grant-date fair value for the portion of the awards that is ultimately expected to vest.

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McKESSON CORPORATION
FINANCIAL NOTES (CONTINUED)
(UNAUDITED)

RSUs, which entitle the holder to receive, at the end of a vesting term, a specified number of shares of the Company's common stock are accounted for at fair value at the date of grant. The fair value of RSUs under our stock plans is determined by the product of the number of shares that are expected to vest and the grant date market price of the Company's common stock. These awards generally vest in four years. We recognize expense for RSUs with a single vest date on a straight-line basis over the requisite service period. We have elected to expense the grant date fair value of RSUs with only graded vesting and service conditions on a straight-line basis over the requisite service period.

PeRSUs are RSUs for which the number of RSUs awarded may be conditional upon the attainment of one or more performance objectives over a specified period. PeRSUs are accounted for as variable awards generally for one year until the performance goals are reached and the grant date is established. The fair value of PeRSUs is determined by the product of the number of shares eligible to be awarded and expected to vest, and the market price of the Company's common stock, commencing at the inception of the requisite service period. During the performance period, the PeRSUs are re-valued using the market price and the performance modifier at the end of a reporting period. At the end of the performance period, if the goals are attained, the awards are granted and classified as RSUs and accounted for on that basis. For PeRSUs granted prior to 2009 with multiple vest dates, we recognize the fair value expense of these awards on a graded vesting basis over the requisite service period of four years. PeRSUs granted during 2009 and after and the related RSUs (when they are granted) have a single vest date for which we recognize expense on a straight-line basis over the four year service period.

Compensation expense for the share-based awards is recognized for the portion of the awards that is ultimately expected to vest. We develop an estimate of the number of share-based awards, which will ultimately vest primarily based on historical experience. The estimated forfeiture rate established upon grant is re-assessed throughout the requisite service period. As required, the forfeiture estimates are adjusted to reflect actual forfeitures when an award vests. The actual forfeitures in future reporting periods could be higher or lower than current estimates.

Compensation expense recognized is classified in the condensed consolidated statements of operations or capitalized on the condensed consolidated balance sheets in the same manner as cash compensation paid to our employees. There was no material share-based compensation expense capitalized as part of the cost of an asset for the quarters and nine months ended December 31, 2010 and 2009.

The components of share-based compensation expense and the related tax benefit for the quarters and nine months ended December 31, 2010 and 2009 are shown in the following table:

<i>(In millions)</i>	Quarter Ended		Nine Months Ended	
	December 31,		December 31,	
	2010	2009	2010	2009
RSUs ⁽¹⁾	\$ 18	\$ 11	\$ 61	\$ 37
PeRSUs ⁽²⁾	7	12	15	25
Stock options	6	5	17	14
Employee stock purchase plan	2	2	6	7
Share-based compensation expense	33	30	99	83
Tax benefit for share-based compensation expense ⁽³⁾	(12)	(11)	(35)	(30)
Share-based compensation expense, net of tax	\$ 21	\$ 19	\$ 64	\$ 53

(1) This expense was primarily the result of PeRSUs awarded in prior years, which converted to RSUs due to the attainment of goals during the applicable years' performance period.

- (2) Represents estimated compensation expense for PeRSUs that are conditional upon attaining performance objectives during the current year's performance period.
- (3) Income tax expense is computed using the tax rates of applicable tax jurisdictions. Additionally, a portion of pre-tax compensation expense is not tax-deductible.

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**McKESSON CORPORATION
FINANCIAL NOTES (CONTINUED)
(UNAUDITED)**

Share-based compensation expense is affected by our stock price, the number and type of annual share-based awards as well as assumptions regarding a number of complex and subjective variables and the related tax impact. These variables include, but are not limited to, the volatility of our stock price, employee stock option exercise behavior and the attainment of performance goals. As a result, the actual future share-based compensation expense may differ from historical amounts.

6. Income Taxes

As of December 31, 2010, we had \$674 million of unrecognized tax benefits, of which \$438 million would reduce income tax expense and the effective tax rate if recognized. During the next twelve months, it is reasonably possible that audit resolutions and the expiration of statutes of limitations could potentially reduce our unrecognized tax benefits by up to \$2 million. However, this amount may change because we continue to have ongoing negotiations with various taxing authorities throughout the year.

We have received assessments of \$169 million, including tax and interest, from the Canada Revenue Agency and certain provinces related to a transfer pricing issue for 2003 through 2007. We have appealed the assessment for 2003 to the Canadian Tax Court and have filed a notice of objection for 2004 through 2007. Payments of most of the assessments have been made to stop the accrual of interest. We believe that we have adequately provided for any potential adverse results.

In nearly all jurisdictions, the tax years prior to 2003 are no longer subject to examination. We believe that we have made adequate provision for all remaining income tax uncertainties.

We continue to report interest and penalties on tax deficiencies as income tax expense. At December 31, 2010, before any tax benefits, our accrued interest on unrecognized tax benefits amounted to \$128 million. We recognized an income tax expense of \$4 million and \$13 million, before any tax effect, related to interest in our condensed consolidated statements of operations during the third quarter and nine months ended December 31, 2010. We have no material amounts accrued for penalties.

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McKESSON CORPORATION
FINANCIAL NOTES (CONTINUED)
(UNAUDITED)

7. Earnings Per Common Share

Basic earnings per common share are computed by dividing net income by the weighted average number of common shares outstanding during the reporting period. Diluted earnings per common share are computed similar to basic earnings per common share except that it reflects the potential dilution that could occur if dilutive securities or other obligations to issue common stock were exercised or converted into common stock.

The computations for basic and diluted earnings per common share are as follows:

<i>(In millions, except per share amounts)</i>	Quarter Ended		Nine Months Ended	
	December 31,		December 31,	
	2010	2009	2010	2009
Income from continuing operations	\$ 155	\$ 326	\$ 708	\$ 915
Discontinued operation gain on sale, net of tax			72	
Net income	\$ 155	\$ 326	\$ 780	\$ 915
Weighted average common shares outstanding:				
Basic	254	269	259	269
Effect of dilutive securities:				
Options to purchase common stock	2	3	3	3
Restricted stock/ restricted stock units	2	2	2	1
Diluted ⁽¹⁾	258	274	264	272
Earnings Per Common Share: ⁽¹⁾				
Diluted				
Continuing operations	\$ 0.60	\$ 1.19	\$ 2.69	\$ 3.36
Discontinued operation gain on sale			0.27	
Total				