MCKESSON CORP
Form 10-Q
October 31, 2007

Table of Contents

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 quarter ended September 30, 2007

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

For the transition period from ____________ to ____________

Commission file number 1-13252

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

Delaware	**94-3207296**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**
One Post Street, San Francisco, California	**94104**
(Address of principal executive offices)	**(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 þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

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 September 30, 2007
Common stock, $0.01 par value	**289,387,335 shares**

McKESSON CORPORATION
TABLE OF CONTENTS

Item		Page
	PART I. FINANCIAL INFORMATION	
1.	Condensed Consolidated Financial Statements	
	Condensed Consolidated Balance Sheets September 30, 2007 and March 31, 2007	3
	Condensed Consolidated Statements of Operations Quarters and Six Months ended September 30, 2007 and 2006	4
	Condensed Consolidated Statements of Cash Flows Six Months ended September 30, 2007 and 2006	5
	Financial Notes	6
2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	19-29
3.	Quantitative and Qualitative Disclosures about Market Risk	30
4.	Controls and Procedures	30
	PART II. OTHER INFORMATION	
1.	Legal Proceedings	30
1A.	Risk Factors	30
2.	Unregistered Sales of Equity Securities and Use of Proceeds	30
3.	Defaults Upon Senior Securities	31
4.	Submission of Matters to a Vote of Security Holders	31
5.	Other Information	31
6.	Exhibits	32
	Signatures	32

Exhibit 3.1
Exhibit 10.1
EXHIBIT 31.1
EXHIBIT 31.2
EXHIBIT 32

Table of Contents

McKESSON CORPORATION
PART I. FINANCIAL INFORMATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(In millions, except per share amounts)
(Unaudited)

	September 30, 2007	March 31, 2007
ASSETS		
Current Assets		
Cash and cash equivalents	$ 2,518	$ 1,954
Restricted cash	967	984
Receivables, net	6,820	6,566
Inventories	8,303	8,153
Prepaid expenses and other	181	199
Total	18,789	17,856
Property, Plant and Equipment, Net	714	684
Capitalized Software Held for Sale, Net	185	166
Goodwill	3,055	2,975
Intangible Assets, Net	578	613
Other Assets	1,713	1,649
Total Assets	$ 25,034	$ 23,943
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Drafts and accounts payable	$ 11,773	$ 10,873
Deferred revenue	970	1,027
Current portion of long-term debt	152	155
Securities Litigation	994	983
Other accrued	1,723	2,088
Total	15,612	15,126
Other Noncurrent Liabilities	1,240	741
Long-Term Debt	1,798	1,803
Other Commitments and Contingent Liabilities (Note 12)		
Stockholders Equity		
Preferred stock, $0.01 par value, 100 shares authorized, no shares issued or outstanding		
Common stock, $0.01 par value	3	3
Shares authorized: September 30, 2007 and March 31, 2007 800		

Shares issued: September 30, 2007 347 and March 31, 2007 341				
Additional Paid-in Capital		3,999		3,722
Other Capital		(18)		(19)
Retained Earnings		5,113		4,712
Accumulated Other Comprehensive Income		150		31
ESOP Notes and Guarantees		(6)		(14)
Treasury Shares, at Cost, September 30, 2007 58 and March 31, 2007 46		(2,857)		(2,162)
Total Stockholders Equity		6,384		6,273
Total Liabilities and Stockholders Equity	$	25,034	$	23,943

See Financial Notes

3

Table of Contents

McKESSON CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In millions, except per share amounts)
(Unaudited)

	Quarter Ended September 30, 2007	Quarter Ended September 30, 2006	Six Months Ended September 30, 2007	Six Months Ended September 30, 2006
Revenues	$ 24,450	$ 22,386	$ 48,978	$ 45,701
Cost of Sales	23,269	21,362	46,620	43,681
Gross Profit	1,181	1,024	2,358	2,020
Operating Expenses	827	724	1,648	1,448
Securities Litigation Credit, Net	(5)	(6)	(5)	(6)
Total Operating Expenses	822	718	1,643	1,442
Operating Income	359	306	715	578
Other Income, Net	36	32	73	67
Interest Expense	(36)	(22)	(72)	(45)
Income from Continuing Operations Before Income Taxes	359	316	716	600
Income Tax Provision	(112)	(29)	(233)	(129)
Income from Continuing Operations	247	287	483	471
Discontinued Operations, net		(6)	(1)	(6)
Discontinued Operations loss on sale, net		(52)		(52)
Total Discontinued Operations		(58)	(1)	(58)
Net Income	$ 247	$ 229	$ 482	$ 413
Earnings Per Common Share				
Diluted				
Continuing operations	$ 0.83	$ 0.94	$ 1.60	$ 1.54
Discontinued operations		(0.02)		(0.02)
Discontinued operations loss on sale, net		(0.17)		(0.17)
Total	$ 0.83	$ 0.75	$ 1.60	$ 1.35
Basic				
Continuing operations	$ 0.85	$ 0.96	$ 1.64	$ 1.57
Discontinued operations		(0.02)		(0.02)
Discontinued operations loss on sale, net		(0.17)		(0.17)
Total	$ 0.85	$ 0.77	$ 1.64	$ 1.38

Dividends Declared Per Common Share	$ 0.06	$ 0.06	$ 0.12	$ 0.12
Weighted Average Shares				
Diluted	299	305	302	307
Basic	293	298	295	300

See Financial Notes

4

Table of Contents

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

	Six Months Ended September 30,	
	2007	**2006**
Operating Activities		
Net income	$ 482	$ 413
Discontinued operations, net of income taxes	1	58
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation and amortization	178	139
Securities Litigation credit, net	(5)	(6)
Deferred taxes	41	70
Share-based compensation expense	47	24
Excess tax benefits from share-based payment arrangements	(43)	(36)
Other non-cash items	19	(3)
Total	720	659
Changes in operating assets and liabilities, net of business acquisitions:		
Receivables	(162)	256
Inventories	(65)	(635)
Drafts and accounts payable	791	454
Deferred revenue	(90)	12
Taxes	192	33
Other	(114)	(94)
Total	552	26
Net cash provided by operating activities	1,272	685
Investing Activities		
Property acquisitions	(83)	(51)
Capitalized software expenditures	(78)	(86)
Acquisitions of businesses, less cash and cash equivalents acquired	(51)	(95)
Proceeds from sale of businesses		175
Other	(16)	(52)
Net cash used in investing activities	(228)	(109)
Financing Activities		
Repayment of debt	(8)	(8)
Capital stock transactions:		
Issuances	183	191

Share repurchases	(695)	(658)
Excess tax benefits from share-based payment arrangements	43	36
ESOP notes and guarantees	8	7
Dividends paid	(36)	(36)
Other	7	1
Net cash used in financing activities	(498)	(467)
Effect of exchange rate changes on cash and cash equivalents	18	6
Net increase in cash and cash equivalents	564	115
Cash and cash equivalents at beginning of period	1,954	2,139
Cash and cash equivalents at end of period	$ 2,518	$ 2,254

See Financial Notes

Table of Contents

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 majority-owned or controlled companies. Significant intercompany transactions and balances have been eliminated. 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 September 30, 2007, and the results of operations for the quarters and six months ended September 30, 2007 and 2006 and cash flows for the six months ended September 30, 2007 and 2006.

The results of operations for the quarters and six months ended September 30, 2007 and 2006 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 2007 consolidated financial statements previously filed with the Securities and Exchange Commission. As described in our Annual Report on Form 10-K for the year ended March 31, 2007, we realigned our businesses on April 1, 2007. This realignment resulted in changes to our reporting segments. On May 30, 2007, we provided financial information about the changes in our reporting segments, as it relates to prior periods, in a Form 8-K. 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.

New Accounting Pronouncements. On April 1, 2007, we adopted Financial Accounting Standards Board Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes. Among other things, FIN No. 48 requires application of a more likely than not threshold for the recognition and derecognition of tax positions. It further requires that a change in judgment related to prior years tax positions be recognized in the quarter of such change. The April 1, 2007 adoption of FIN No. 48 resulted in a reduction of our retained earnings by $48 million.

Annually, we file a federal consolidated income tax return with the U.S., and over 1,100 returns with various state and foreign jurisdictions. Our major taxing jurisdictions are the U.S. and Canada. In the U.S., the Internal Revenue Service (IRS) has completed an examination of our consolidated income tax returns for 2000 to 2002 resulting in a signed Revenue Agent Report (RAR), which is subject to approval by the Joint Committee on Taxation. The IRS and the Company have agreed to certain adjustments, principally related to transfer pricing. We have made adequate provisions related to the 2000 to 2002 IRS audit and, therefore, believe the outcome of this RAR is not likely to have a material adverse impact on our financial position, cash flows or results of operations. We further believe that we have made adequate provision for all remaining income tax uncertainties. In Canada, we are under examination for 2002 to 2005. In nearly all jurisdictions, the tax years prior to 1999 are no longer subject to examination.

At April 1, 2007, our unrecognized tax benefits, defined as the aggregate tax effect of differences between tax return positions and the benefits recognized in our financial statements, amounted to $465 million. This amount increased by $23 million during the six months ended September 30, 2007. If recognized, $292 million of our unrecognized tax benefits would reduce income tax expense and the effective tax rate. During the next 12 months, it is reasonably possible that audit resolutions and expiration of statutes of limitations could potentially reduce our unrecognized tax benefits by up to $124 million.

We continue to report interest and penalties on tax deficiencies as income tax expense. At April 1, 2007, before any tax benefits, our accrued interest on unrecognized tax benefits amounted to $95 million. This amount increased by $11 million during the six months ended September 30, 2007. We have no amounts accrued for penalties.

Effective March 31, 2007, we adopted Statement of Financial Accounting Standards (SFAS) No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans. SFAS No. 158 required the Company to record a transition adjustment to recognize the funded status of pension and postretirement defined benefit plans measured as the difference between the fair value of plan assets and the benefit obligations in our balance sheet after adjusting for derecognition of the Company s minimum pension liability as of March 31, 2007.

McKESSON CORPORATION
FINANCIAL NOTES (CONTINUED)
(UNAUDITED)

Subsequent to the issuance of the Company s 2007 Annual Report on Form 10-K, it was determined that we incorrectly presented the SFAS No. 158 transition adjustment of $63 million, net, as a reduction of 2007 comprehensive income within our Consolidated Statement of Stockholders Equity for the year ended March 31, 2007. We will correct this error when we file the Company s 2008 Annual Report on Form 10-K, increasing previously reported comprehensive income from $889 million to $952 million for the fiscal year ended March 31, 2007.

2. Acquisitions and Investments

In 2007, we made the following acquisitions and investments:

On January 26, 2007, we acquired all of the outstanding shares of Per-Se Technologies, Inc. (Per-Se) of Alpharetta, Georgia for $28.00 per share in cash plus the assumption of Per-Se s debt, or approximately $1.8 billion in aggregate, including cash acquired of $76 million. Per-Se is a leading provider of financial and administrative healthcare solutions for hospitals, physicians and retail pharmacies. Financial results for Per-Se are primarily included within our Technology Solutions segment since the date of acquisition. The acquisition was initially funded with cash on hand and through the use of an interim credit facility. In March 2007, we issued $1 billion of long-term debt, with such net proceeds after offering expenses from the issuance, together with cash on hand, being used to fully repay borrowings outstanding under the interim credit facility.

The following table summarizes the preliminary estimated fair values of the assets acquired and liabilities assumed in the acquisition as of September 30, 2007:

(In millions)	
Accounts receivable	$ 107
Property and equipment	41
Other current and noncurrent assets	92
Goodwill	1,252
Intangible assets	471
Accounts payable	(8)
Other current liabilities	(119)
Deferred revenue	(30)
Long-term liabilities	(71)
Net assets acquired, less cash and cash equivalents	$ 1,735

Approximately $1,252 million of the preliminary purchase price allocation has been assigned to goodwill. Included in the purchase price allocation are acquired identifiable intangibles of $402 million representing customer relationships with a weighted-average life of 10 years, developed technology of $56 million with a weighted-average life of 5 years, and trademarks and tradenames of $13 million with a weighted-average life of 5 years.

Our Technology Solutions segment acquired RelayHealth Corporation (RelayHealth) based in Emeryville, California. RelayHealth is a provider of secure online healthcare communication services linking patients, healthcare professionals, payors and pharmacies. This segment also acquired two other entities, one specializing in patient billing solutions designed to simplify and enhance healthcare providers financial interactions with their patients, as well as a provider of integrated software for electronic health records, medical billing and appointment scheduling for independent physician practices. The total cost of these three entities was $90 million, which was paid in cash. Goodwill recognized in these transactions amounted to

$63 million.

Table of Contents

McKESSON CORPORATION
FINANCIAL NOTES (CONTINUED)
(UNAUDITED)

Our Distribution Solutions segment acquired Sterling Medical Services LLC (Sterling) based in Moorestown, New Jersey. Sterling is a national provider and distributor of disposable medical supplies, health management services and quality management programs to the home care market. This segment also acquired a medical supply sourcing agent. The total cost of these two entities was $95 million, which was paid in cash. Goodwill recognized in these transactions amounted to $47 million.

We contributed $36 million in cash and $45 million in net assets, primarily from our Automated Prescription Systems business, to Parata Systems, LLC (Parata), in exchange for a minority interest in Parata. Parata is a manufacturer of pharmacy robotic equipment. In connection with the investment, we abandoned certain assets which resulted in a $15 million charge to cost of sales and incurred $6 million of other expenses related to the transaction which were recorded within operating expenses. We did not recognize any additional gains or losses as a result of this transaction as we believe the fair value of our investment in Parata approximates the carrying value of consideration contributed to Parata. Our investment in Parata is accounted for under the equity method of accounting within our Distribution Solutions segment.

During the last two years, we also completed a number of other smaller acquisitions and investments 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 and, for certain recent acquisitions, may be subject to change. Goodwill recognized for our business acquisitions is 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. Discontinued Operations

In the second quarter of 2007, we completed the following divestitures:

Our Distribution Solutions segment sold its Acute Care medical-surgical supply business to Owens & Minor, Inc. for net cash proceeds of approximately $160 million. The divestiture resulted in an after-tax loss of $61 million, which included a $79 million non-tax deductible write-off of goodwill. We allocated a portion of our goodwill to the Acute Care business as required by SFAS No. 142, Goodwill and Other Intangible Assets. The allocation was based on the relative fair values of the Acute Care business and the continuing businesses that are being retained by the Company. The fair value of the Acute Care business was determined based on the net cash proceeds resulting from the divestiture. As a result, we allocated $79 million of the segment s goodwill to the Acute Care business.

Our Distribution Solutions segment also sold a wholly-owned subsidiary, Pharmaceutical Buyers Inc., for net cash proceeds of $10 million. The divestiture generated an after-tax gain of $5 million resulting from the tax basis of the subsidiary exceeding its carrying value. The financial results for this business were not material to our condensed consolidated financial statements.

In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the financial results of these businesses are classified as discontinued operations for all periods presented in the accompanying condensed consolidated financial statements.

Table of Contents

McKESSON CORPORATION
FINANCIAL NOTES (CONTINUED)
(UNAUDITED)

4. Share-Based Payment

We provide share-based compensation for our employees, officers and non-employee directors, including stock options, an employee stock purchase plan, restricted stock (RS), restricted stock units (RSUs) and performance-based restricted stock units (PeRSUs) (collectively, share-based awards). PeRSUs are RSUs for which the number of RSUs awarded is conditional upon the attainment of one or more performance objectives over a specified performance period, typically one year. At the end of the performance period, if the goals are attained, the award is classified as a RSU and is accounted for on that basis.

Share-based compensation expense is measured based on the grant-date fair value of the share-based awards. For those awards with graded vesting and service conditions, we recognize compensation expense for the portion of the awards that is ultimately expected to vest on a straight-line basis over the requisite service period. For PeRSUs that have been converted to RSUs, we recognize the expense on a straight-line basis primarily over three years and treat each vesting tranche as a separate award. We develop an estimate of the number of share-based awards which will ultimately vest primarily based on historical experience. The estimated forfeiture rate is adjusted throughout the requisite service period. As required, forfeiture estimates are adjusted to reflect actual forfeiture and vesting activity as they occur.

Compensation expense recognized for share-based compensation has been classified in the income statement or capitalized on the balance sheet in the same manner as cash compensation paid to our employees. There was no material share-based compensation expense capitalized in the balance sheet as of September 30, 2007.

Most of the Company s share-based awards are granted in the first quarter of each fiscal year. The components of share-based compensation expense and the related tax benefit are shown in the following table:

	Quarter Ended September 30,		Six Months Ended September 30,	
(In millions, except per share amounts)	**2007**	**2006**	**2007**	**2006**
RSUs and RS [1]	$ 14	$ 6	$ 27	$ 9
PeRSUs [2]	8	6	10	8
Stock options	4	2	6	3
Employee stock purchase plan	2	2	4	4
Share-based compensation expense	28	16	47	24
Tax benefit for share-based compensation expense	(10)	(6)	(17)	(8)
Share-base compensation expense, net of tax [3]	$ 18	$ 10	$ 30	$ 16
Impact of share-based compensation:				
Earnings per share				
Diluted	$0.06	$0.03	$0.10	$0.05
Basic	0.06	0.03	0.10	0.05

(1) Substantially all of the 2008 expense was the result of our 2007 PeRSUs

that have been converted to RSUs in 2008 due to the attainment of goals during the 2007 performance period.

(2) Represents estimated compensation expense for PeRSUs that are conditional upon attaining performance objectives during the 2008 and 2007 performance periods.

(3) No material share-based compensation expense was included in Discontinued Operations.

Table of Contents

McKESSON CORPORATION
FINANCIAL NOTES (CONTINUED)
(UNAUDITED)

Due to the accelerated vesting of share-based awards prior to 2007, we anticipate the impact of SFAS No. 123(R), Share-Based Payment, to increase in significance as future awards of share-based compensation are granted and amortized over the requisite service period. Share-based compensation charges are affected by our stock price 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, timing, level and types of our grants of annual share-based awards, the attainment of performance goals and actual forfeiture rates. As a result, the actual future share-based compensation expense may differ from historical levels of expense.

5. Income Taxes

During the second quarter of 2007, we recorded a credit to income tax expense of $83 million which primarily pertains to our receipt of a private letter ruling from the IRS holding that our payment of approximately $960 million to settle the Consolidated Action (see Financial Note 12, Other Commitments and Contingent Liabilities) is fully tax-deductible. We previously established tax reserves to reflect the lack of certainty regarding the tax deductibility of settlement amounts paid in the Consolidated Action and related litigation.

6. Restructuring Activities

The following table summarizes the activity related to our restructuring liabilities.

	Distribution Solutions		Technology Solutions		
(In millions)	**Severance**	**Exit-Related**	**Severance**	**Exit-Related**	**Total**
Balance, March 31, 2007	$ 3	$ 6	$ 16	$ 5	$ 30
Cash expenditures	(1)	(2)	(13)	(1)	(17)
Adjustments to liabilities related to Per-Se acquisition			9		9
Other	(2)	1	(1)		