BROWN FORMAN CORP
Form 10-Q
December 02, 2015
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, 2015
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. 002-26821

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

Delaware (State or other jurisdiction of incorporation or organization)	61-0143150 (IRS Employer Identification No.)
850 Dixie Highway Louisville, Kentucky (Address of principal executive offices)	40210 (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 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post 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, 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 þ	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No 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, 2015

Class A Common Stock ($.15 par value, voting)	84,528,000
Class B Common Stock ($.15 par value, nonvoting)	116,819,323

Table of Contents

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

Table of Contents

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

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

	Three Months Ended October 31,		Six Months Ended October 31,	
	2014	2015	2014	2015
Net sales	$1,135	$1,096	$2,056	$1,995
Excise taxes	258	242	474	444
Cost of sales	268	268	478	475
Gross profit	609	586	1,104	1,076
Advertising expenses	123	115	223	209
Selling, general, and administrative expenses	178	171	348	340
Other expense (income), net	5	(2)	10	(2)
Operating income	303	302	523	529
Interest income	—	—	1	1
Interest expense	7	12	14	22
Income before income taxes	296	290	510	508
Income taxes	88	90	152	152
Net income	$208	$200	$358	$356
Earnings per share:				
Basic	$0.98	$0.98	$1.68	$1.73
Diluted	$0.97	$0.97	$1.67	$1.72
Cash dividends per common share:				
Declared	$—	$—	$0.580	$0.630
Paid	$0.290	$0.315	$0.580	$0.630

See notes to the condensed consolidated financial statements.

Table of Contents

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

	Three Months Ended October 31,		Six Months Ended October 31,	
	2014	2015	2014	2015
Net income	$208	$200	$358	$356
Other comprehensive income (loss), net of tax:				
Currency translation adjustments	(30)	(4)	(46)	(28)
Cash flow hedge adjustments	22	(4)	27	12
Postretirement benefits adjustments	12	6	16	10
Net other comprehensive income (loss)	4	(2)	(3)	(6)
Comprehensive income	$212	$198	$355	$350

See notes to the condensed consolidated financial statements.

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

	April 30, 2015	October 31, 2015
Assets		
Cash and cash equivalents	$370	$195
Accounts receivable, less allowance for doubtful accounts of $10 and $10 at April 30 and October 31, respectively	583	727
Inventories:		
Barreled whiskey	571	604
Finished goods	200	251
Work in process	121	124
Raw materials and supplies	61	88
Total inventories	953	1,067
Current deferred tax assets	16	18
Other current assets	332	341
Total current assets	2,254	2,348
Property, plant and equipment, net	586	619
Goodwill	607	606
Other intangible assets	611	608
Deferred tax assets	18	17
Other assets	112	121
Total assets	$4,188	$4,319
Liabilities		
Accounts payable and accrued expenses	$497	$549
Accrued income taxes	12	16
Current deferred tax liabilities	9	12
Short-term borrowings	190	303
Current portion of long-term debt	250	250
Total current liabilities	958	1,130
Long-term debt	743	1,229
Deferred tax liabilities	107	116
Accrued pension and other postretirement benefits	311	300
Other liabilities	164	143
Total liabilities	2,283	2,918
Commitments and contingencies		
Stockholders' Equity		
Common stock:		
Class A, voting (85,000,000 shares authorized; 85,000,000 shares issued)	13	13
Class B, nonvoting (400,000,000 shares authorized; 142,313,000 shares issued)	21	21
Additional paid-in capital	99	115
Retained earnings	3,300	3,508
Accumulated other comprehensive income (loss), net of tax	(300)	(306)
Treasury stock, at cost (18,613,000 and 25,971,000 shares at April 30 and October 31, respectively)	(1,228)	(1,950)
Total stockholders' equity	1,905	1,401
Total liabilities and stockholders' equity	$4,188	$4,319

See notes to the condensed consolidated financial statements.

Table of Contents

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

	Six Months Ended October 31, 2014	2015
Cash flows from operating activities:		
Net income	$358	$356
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	25	27
Stock-based compensation expense	6	8
Deferred income taxes	(18)	(8)
Changes in assets and liabilities	(301)	(222)
Cash provided by operating activities	70	161
Cash flows from investing activities:		
Additions to property, plant, and equipment	(59)	(65)
Acquisition of brand names and trademarks	(3)	—
Computer software expenditures	(1)	(1)
Cash used for investing activities	(63)	(66)
Cash flows from financing activities:		
Net change in short-term borrowings	117	113
Proceeds from long-term debt	—	490
Debt issuance costs	—	(5)
Net payments related to exercise of stock-based awards	(6)	(6)
Excess tax benefits from stock-based awards	17	13
Acquisition of treasury stock	(205)	(739)
Dividends paid	(124)	(130)
Cash used for financing activities	(201)	(264)
Effect of exchange rate changes on cash and cash equivalents	(8)	(6)
Net decrease in cash and cash equivalents	(202)	(175)
Cash and cash equivalents, beginning of period	437	370
Cash and cash equivalents, end of period	$235	$195

See notes to the condensed consolidated financial statements.

Table of Contents

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

In these notes, “we,” “us,” and “our” refer to Brown-Forman Corporation.

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 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). 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, 2015 (the 2015 Form 10-K).

In our opinion, the accompanying financial statements include all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of our financial results for the periods covered by this report.

We prepared the accompanying financial statements on a basis that is substantially consistent with the accounting principles applied in our 2015 Form 10-K, although during the first quarter of fiscal 2016 we adopted new guidance for the presentation of debt issuance costs. Under the new guidance, debt issuance costs are presented as a direct deduction from the debt liability rather than as an asset. In adopting the new guidance, we retrospectively adjusted our balance sheet as of April 30, 2015. As a result, the carrying amounts of other assets (noncurrent) and long-term debt have decreased by $5 million from the amounts previously reported as of that date.

In May 2014, the Financial Accounting Standards Board (FASB) issued new guidance on the recognition of revenue from contracts with customers. As issued, the new guidance would have become effective for us beginning fiscal 2018. However, the FASB has since deferred the effective date until our fiscal 2019, though permitting voluntary adoption as of the original effective date. The FASB has also proposed further amendments to the new guidance. We are currently evaluating the potential impact of the new guidance and the proposed amendments on our financial statements.

2. Inventories
We use the last-in, first-out (LIFO) method to determine the cost of most of our inventories. If the LIFO method had not been used, inventories at current cost would have been $234 million higher than reported as of April 30, 2015, and $243 million higher than reported as of October 31, 2015. Changes in the LIFO valuation reserve for interim periods are based on a proportionate allocation of the estimated change for the entire fiscal year.

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 quarter in which the related event occurs. The effective tax rate of 29.9% for the six months ended October 31, 2015, is based on an expected tax rate of 30.5% on ordinary income for the full fiscal year, as adjusted for the recognition of a net tax benefit related to discrete items arising during the period and interest on previously provided tax contingencies. Our expected tax rate includes current fiscal year additions for existing tax contingency items.

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, including stock options, stock-settled stock appreciation rights, restricted stock units, deferred stock units, and shares of restricted stock. We calculate that dilutive effect using the "treasury stock method" (as defined by GAAP).

Table of Contents

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)	2014	2015	2014	2015
Net income available to common stockholders	$208	$200	$358	$356
Share data (in thousands):				
Basic average common shares outstanding	212,087	204,055	212,674	205,558
Dilutive effect of stock-based awards	1,482	1,376	1,528	1,375
Diluted average common shares outstanding	213,569	205,431	214,202	206,933
Basic earnings per share	$0.98	$0.98	$1.68	$1.73
Diluted earnings per share	$0.97	$0.97	$1.67	$1.72

We excluded common stock-based awards for approximately 363,000 shares and 415,000 shares from the calculation of diluted earnings per share for the three months ended October 31, 2014 and 2015, respectively. We excluded common stock-based awards for approximately 365,000 shares and 530,000 shares from the calculation of diluted earnings per share for the six months ended October 31, 2014 and 2015, respectively. We excluded those awards because they were not dilutive for those periods under the treasury stock method.

5. 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 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, 2015.

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 $16 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, 2015, our actual exposure under the guaranty of the importer's obligation is approximately $9 million. We also have accounts receivable from that importer of approximately $26 million at October 31, 2015, 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

Table of Contents

6. Debt

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

(Dollars in millions)	April 30, 2015	October 31, 2015
2.50% notes, due in fiscal 2016	$250	$250
1.00% notes, due in fiscal 2018	248	249
2.25% notes, due in fiscal 2023	247	247
3.75% notes, due in fiscal 2043	248	248
4.50% notes, due in fiscal 2046	—	485
	993	1,479
Less current portion	250	250
	$743	$1,229

We issued senior, unsecured notes with an aggregate principal amount of $500 million in June 2015. Interest on the notes will accrue at a rate of 4.5% and be paid semi-annually. As of October 31, 2015, the carrying amount of the notes was $485 million ($500 million principal, less discounts of $10 million and issuance costs of $5 million). The notes are due on July 15, 2045.

As of April 30, 2015, our short-term borrowings of $190 million included $183 million of commercial paper, with an average interest rate of 0.17% and a remaining maturity of 13 days. As of October 31, 2015, our short-term borrowings of $303 million included $295 million of commercial paper, with an average interest rate of 0.21% and a remaining maturity of 21 days.

7. Pension and Other Postretirement Benefits

The following table shows the components of the pension and other postretirement benefit cost recognized for our U.S. benefit plans during the periods covered by this report. Information about similar international plans is not presented due to immateriality.

	Three Months Ended October 31,		Six Months Ended October 31,	
(Dollars in millions)	2014	2015	2014	2015
Pension Benefits:				
Service cost	$5	$6	$11	$13
Interest cost	8	9	17	17
Expected return on plan assets	(10)	(10)	(21)	(20)
Amortization of:				
Prior service cost	—	—	1	—
Net actuarial loss	6	7	11	14
Net cost	$9	$12	$19	$24
Other Postretirement Benefits:				
Service cost	$—	$—	$1	$1
Interest cost	$1	$1	2	1
Amortization of prior service cost	—	(1)	(1)	(1)
Net cost	$1	$—	$2	$1

Table of Contents

8. Fair Value Measurements

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 markets that are not active; or other inputs that are observable or can be derived from or corroborated by observable market data.
- Level 3 – Unobservable inputs that are supported by little or no market activity.

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

(Dollars in millions)	Level 1	Level 2	Level 3	Total
April 30, 2015:				
Assets:				
Currency derivatives	$—	$59	$—	$59
Liabilities:				
Currency derivatives	—	18	—	18
Short-term borrowings	—	190	—	190
Current portion of long-term debt	—	253	—	253
Long-term debt	—	735	—	735
October 31, 2015:				
Assets:				
Currency derivatives	—	68	—	68
Liabilities:				
Currency derivatives	—	4	—	4
Short-term borrowings	—	303	—	303
Current portion of long-term debt	—	251	—	251
Long-term debt	—	1,232	—	1,232

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 exchange rates, forward rates, and discount rates. The discount rates are based on the historical U.S. Treasury rates.

The fair value of short-term borrowings approximates their carrying amount. 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.

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.

Table of Contents

9. Fair Value of Financial Instruments

The fair value of cash, cash equivalents, and short-term borrowings approximate the carrying amounts due to the short maturities of these instruments. We determine the fair value of derivative financial instruments and long-term debt as discussed in Note 8.

Below is a comparison of the fair values and carrying amounts of these instruments:

	April 30, 2015		October 31, 2015	
(Dollars in millions)	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Assets:				
Cash and cash equivalents	$370	$370	$195	$195
Currency derivatives	59	59	68	68
Liabilities:				
Currency derivatives	18	18	4	4
Short-term borrowings	190	190	303	303
Current portion of long-term debt	250	253	250	251
Long-term debt	743	735	1,229	1,232

10. Derivative Financial Instruments

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 do not designate some of our currency derivatives 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 contracts in earnings.

We had outstanding currency derivatives, related primarily to our euro, British pound, and Australian dollar exposures, with notional amounts totaling $1,212 million at April 30, 2015 and $1,289 million at October 31, 2015.

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 derivative instruments.

During May 2015, we entered into interest rate derivative contracts (U.S. treasury lock agreements) to manage the interest rate risk related to the anticipated issuance of fixed-rate senior, unsecured notes. We designated the contracts as cash flow hedges of the future interest payments associated with the anticipated notes. Upon issuance of the notes in June 2015 (see Note 6), we settled the contracts for a gain of $8 million. The entire gain was recorded to AOCI and will be amortized as a reduction of interest expense over the life of the notes.

Table of Contents

The following table presents the pre-tax impact that changes in the fair value of our derivative instruments had on AOCI and earnings during the periods covered by this report:

		Three Months Ended October 31,	
(Dollars in millions)	Classification	2014	2015
Currency derivatives designated as cash flow hedges:			
Net gain (loss) recognized in AOCI	n/a	$42	$9
Net gain (loss) reclassified from AOCI into income	Net sales	6	17
Derivatives not designated as hedging instruments:			
Currency derivatives – net gain (loss) recognized in income	Net sales	11	—
Currency derivatives – net gain (loss) recognized in income	Other income	3	—

		Six Months Ended October 31,	
(Dollars in millions)	Classification	2014	2015
Currency derivatives designated as cash flow hedges:			
Net gain (loss) recognized in AOCI	n/a	$47	$38
Net gain (loss) reclassified from AOCI into income	Net sales	4	30
Interest rate derivatives designated as cash flow hedges:			
Net gain (loss) recognized in AOCI	n/a	—	8
Derivatives not designated as hedging instruments:			
Currency derivatives – net gain (loss) recognized in income	Net sales	8	3
Currency derivatives – net gain (loss) recognized in income	Other income	(6)	4

We expect to reclassify $35 million of deferred net gains recorded in AOCI as of October 31, 2015, 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, 2015, the maximum term of our outstanding derivative contracts was 36 months.

Table of Contents

The following table presents the fair values of our derivative instruments as of April 30, 2015 and October 31, 2015.

(Dollars in millions)	Classification	Fair value of derivatives in a gain position	Fair value of derivatives in a loss position
April 30, 2015:			
Designated as cash flow hedges:			
Currency derivatives	Other current assets	$42	$(2)
Currency derivatives	Other assets	20	(3)
Currency derivatives	Accrued expenses	—	(6)
Currency derivatives	Other liabilities	—	(6)
Not designated as hedges:			
Currency derivatives	Other current assets	3	(1)
Currency derivatives	Accrued expenses	1	(7)
October 31, 2015:			
Designated as cash flow hedges:			
Currency derivatives	Other current assets	44	—
Currency derivatives	Other assets	20	(1)
Currency derivatives	Accrued expenses	—	(3)
Currency derivatives	Other liabilities	1	(2)
Not designated as hedges:			
Currency derivatives	Other current assets	6	(1)

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 that are subject to net settlement agreements are presented in our balance sheets on a net basis.

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 that provide for reports to senior management according to prescribed guidelines, 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 $18 million at April 30, 2015 and $4 million at October 31, 2015.

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

Table of Contents

(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, 2015:					
Derivative assets	$65	$(6)	$59	$—	$59
Derivative liabilities	(24)	6	(18)	—	(18)
October 31, 2015:					
Derivative assets	70	(2)	68	—	68
Derivative liabilities	(6)	2	(4)	—	(4)

No cash collateral was received or pledged related to our derivative contracts as of April 30, 2015 and October 31, 2015.

11. Accumulated Other Comprehensive Income

The following table summarizes the changes in each component of accumulated other comprehensive income (AOCI), net of tax, during the three months ended October 31, 2014 and 2015:

	Currency Translation Adjustments	Cash Flow Hedge Adjustments	Postretirement Benefits Adjustments	Total AOCI
Balance at July 31, 2014	$(10)	$1	$(186)	$(195)
Net other comprehensive income (loss)	(30)	22	12	4
Balance at October 31, 2014	$(40)	$23	$(174)	$(191)
Balance at July 31, 2015	$(132)	$44	$(216)	$(304)
Net other comprehensive income (loss)	(4)	(4)	6	(2)
Balance at October 31, 2015	$(136)	$40	$(210)	$(306)

Table of Contents

The following table presents the components of net other comprehensive income (loss) during the three months ended October 31, 2014 and 2015:

	Pre-Tax	Tax	Net
Three Months Ended October 31, 2014			
Currency translation adjustments	$(32)	$2	$(30)
Cash flow hedge adjustments:			
Net gain (loss) on hedging instruments	42	(16)	26
Reclassification to earnings[1]	(6)	2	(4)
Postretirement benefits adjustments:			
Net actuarial gain (loss) and prior service cost	14	(5)	9
Reclassification to earnings[2]	6	(3)	3
Net other comprehensive income (loss)	$24	$(20)	$4
Three Months Ended October 31, 2015			
Currency translation adjustments	$(4)	$—	$(4)
Cash flow hedge adjustments:			
Net gain (loss) on hedging instruments	9	(3)	6
Reclassification to earnings[1]	(17)	7	(10)
Postretirement benefits adjustments:			
Net actuarial gain (loss) and prior service cost	—	—	—
Reclassification to earnings[2]	9	(3)	6
Net other comprehensive income (loss)	$(3)	$1	$(2)

[1]Pre-tax amount is classified as net sales in the accompanying consolidated statements of operations.
[2]Pre-tax amount is a component of pension and other postretirement benefit expense (as shown in Note 7, except for amounts related to non-U.S. benefit plans about which information is not presented in Note 7 due to immateriality).

The following table summarizes the changes in each component of AOCI, net of tax, during the six months ended October 31, 2014 and 2015:

	Currency Translation Adjustments	Cash Flow Hedge Adjustments	Postretirement Benefits Adjustments	Total AOCI
Balance at April 30, 2014	$6	$(4)	$(190)	$(188)
Net other comprehensive income (loss)	(46)	27	16	(3)
Balance at October 31, 2014	$(40)	$23	$(174)	$(191)
Balance at April 30, 2015	$(108)	$28	$(220)	$(300)
Net other comprehensive income (loss)	(28)	12	10	(6)
Balance at October 31, 2015	$(136)	$40	$(210)	$(306)

Table of Contents

The following table presents the components of net other comprehensive income (loss) during the six months ended October 31, 2014 and 2015:

	Pre-Tax	Tax	Net
Six Months Ended October 31, 2014			
Currency translation adjustments	$(48)	$2	$(46)
Cash flow hedge adjustments:			
Net gain (loss) on hedging instruments	47	(17)	30
Reclassification to earnings[1]	(4)	1	(3)
Postretirement benefits adjustments:			
Net actuarial gain (loss) and prior service cost	14	(5)	9
Reclassification to earnings[2]	12	(5)	7
Net other comprehensive income (loss)	$21	$(24)	$(3)
Six Months Ended October 31, 2015			
Currency translation adjustments	$(27)	$(1)	$(28)
Cash flow hedge adjustments:			
Net gain (loss) on hedging instruments	46	(15)	31
Reclassification to earnings[1]	(30)	11	(19)
Postretirement benefits adjustments:			
Net actuarial gain (loss) and prior service cost	—	—	—
Reclassification to earnings[2]	16	(6)	10
Net other comprehensive income (loss)	$5	$(11)	$(6)

[1]Pre-tax amount is classified as net sales in the accompanying consolidated statements of operations.
[2]Pre-tax amount is a component of pension and other postretirement benefit expense (as shown in Note 7, except for amounts related to non-U.S. benefit plans about which information is not presented in Note 7 due to immateriality).

12. Subsequent Event

As announced on November 19, 2015, our Board of Directors increased our quarterly cash dividend on our Class A and Class B common stock from $0.315 per share to $0.340 per share. Stockholders of record on December 3, 2015, will receive the cash dividend on December 30, 2015.

Table of Contents

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

You should read the following discussion and analysis in conjunction with both our unaudited condensed consolidated financial statements and related notes included in Part I, Item 1 of this Quarterly Report and our 2015 Form 10-K. Note that the results of operations for the six months ended October 31, 2015 do not necessarily indicate what our operating results for the full fiscal year will be. In this Item, “we,” “us,” and “our” refer to Brown-Forman Corporation.

Volume and Depletions

When discussing volume, unless otherwise specified, we refer to “depletions,” a term commonly used in the beverage alcohol industry. We define “depletions” as either (a) our shipments directly to retailers or wholesalers, or (b) shipments from our distributor customers to retailers and wholesalers. Because we generally record revenues when we ship our products to our customers, our reported sales for a period do not necessarily reflect actual consumer purchases during that period. We believe that our depletions measure volume in a way that more closely reflects consumer demand than our shipments to distributor customers do.

Volume is discussed on a nine-liter equivalent unit basis (nine-liter cases) unless otherwise specified. At times, we use a “drinks-equivalent” measure for volume when comparing single-serve ready-to-drink (RTD) or ready-to-pour (RTP) brands to a parent spirits brand. “Drinks-equivalent” depletions are RTD and RTP nine-liter cases converted to nine-liter cases of a parent brand on the basis of the number of drinks in one nine-liter case of the parent brand. To convert RTD volumes from a nine-liter case basis to a drinks-equivalent nine-liter case basis, RTD nine-liter case volumes are divided by 10, while RTP nine-liter case volumes are divided by 5.

Non-GAAP Financial Measures

We use certain financial measures in this report that are not measures of financial performance under GAAP. These non-GAAP measures, which are defined below, should be viewed as supplements to (not substitutes for) our results of operations and other measures reported under GAAP. The non-GAAP measures we use in this report may not be defined and calculated by other companies in the same manner.

We present changes in certain income statement line items that are adjusted to an “underlying” basis, which we believe assists in understanding both our performance from period to period on a consistent basis, and the trends of our business. Non-GAAP “underlying” measures include changes in (a) underlying net sales, (b) underlying cost of sales, (c) underlying excise taxes, (d) underlying gross profit, (e) underlying advertising expenses, (f) underlying selling, general, and administrative expenses, and (g) underlying operating income. To calculate each of these measures, we adjust for (a) foreign currency exchange and (b) if applicable, estimated net changes in distributor inventories. We explain these adjustments below.

- “Foreign exchange.” We calculate the percentage change in our income statement line-items in accordance with GAAP and adjust to exclude the cost or benefit of currency fluctuations. Adjusting for foreign exchange allows us to understand our business on a constant dollar basis, as fluctuations in exchange rates can distort the underlying trend both positively and negatively. (In this report, “dollar” always means the U.S. dollar unless stated otherwise.) To eliminate the effect of foreign exchange fluctuations when comparing across periods, we translate current-period results at prior-period rates.
- “Estimated net change in distributor inventories.” This measure refers to the estimated net effect of changes in distributor inventories on changes in our measures. For each period being compared, we estimate the effect of distributor inventory changes on our results using depletion information provided to us by our distributors. We believe that this adjustment reduces the effect of varying levels of distributor inventories on changes in our measures and allows us to understand better our underlying results and trends.

Management uses “underlying” measures of performance to assist it in comparing and measuring our performance from period to period on a consistent basis, and in comparing our performance to that of our competitors. We also use underlying measures as metrics in connection with management incentive compensation calculations. Management also uses underlying measures in its planning and forecasting and in communications with the board of directors, stockholders, analysts, and investors concerning our financial performance. We have provided reconciliations of the non-GAAP measures adjusted to an “underlying” basis to their nearest GAAP measures in the tables below under

“Results of Operations – Year-Over-Year Period Comparisons” and have consistently applied the adjustments within our reconciliations in arriving at each non-GAAP measure.

Table of Contents

Important Information on Forward-Looking Statements:
This report contains statements, estimates, and projections that are “forward-looking statements” as defined under U.S. federal securities laws. Words such as “aim,” “anticipate,” “aspire,” “believe,” “continue,” “could,” “envision,” “estimate,” “ex “expectation,” “intend,” “may,” “plan,” “potential,” “project,” “pursue,” “see,” “seek,” “should,” “will,” and similar words ide forward-looking statements, which speak only as of the date we make them. Except as required by law, we do not intend to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise. By their nature, forward-looking statements involve risks, uncertainties, and other factors (many beyond our control) that could cause our actual results to differ materially from our historical experience or from our current expectations or projections. These risks and uncertainties include those described in Part I, Item 1A. Risk Factors of our 2015 Form 10-K and those described from time to time in our future reports filed with the Securities and Exchange Commission, including:

- Unfavorable global or regional economic conditions, and related low consumer confidence, high unemployment, weak credit or capital markets, budget deficits, burdensome government debt, austerity measures, higher interest rates, higher taxes, political instability, higher inflation, deflation, lower returns on pension assets, or lower discount rates for pension obligations
- Risks associated with being a U.S.-based company with global operations, including commercial, political, and financial risks; local labor policies and conditions; protectionist trade policies or economic or trade sanctions; compliance with local trade practices and other regulations, including anti-corruption laws; terrorism; and health pandemics
- Fluctuations in foreign currency exchange rates, particularly a stronger U.S. dollar
- Changes in laws, regulations, or policies – especially those that affect the production, importation, marketing, labeling, pricing, distribution, sale, or consumption of our beverage alcohol products
- Tax rate changes (including excise, sales, VAT, tariffs, duties, corporate, individual income, dividends, capital gains) or changes in related reserves, changes in tax rules (for example, LIFO, foreign income deferral, U.S. manufacturing, and other deductions) or accounting standards, and the unpredictability and suddenness with which they can occur
- Dependence upon the continued growth of the Jack Daniel’s family of brands
- Changes in consumer preferences, consumption, or purchase patterns – particularly away from larger producers in favor of smaller distilleries or local producers, or away from brown spirits, our premium products, or spirits generally, and our ability to anticipate or react to them; bar, restaurant, travel, or other on-premise declines; shifts in demographic trends; or unfavorable consumer reaction to new products, line extensions, package changes, product reformulations, or other product innovation
- Decline in the social acceptability of beverage alcohol products in significant markets
- Production facility, aging warehouse, or supply chain disruption
- Imprecision in supply/demand forecasting
- Higher costs, lower quality, or unavailability of energy, water, raw materials, product ingredients, labor, or finished goods
- Route-to-consumer changes that affect the timing of our sales, temporarily disrupt the marketing or sale of our products, or result in higher implementation-related or fixed costs
- Inventory fluctuations in our products by distributors, wholesalers, or retailers
- Competitors’ consolidation or other competitive activities, such as pricing actions (including price reductions, promotions, discounting, couponing, or free goods), marketing, category expansion, product introductions, or entry or expansion in our geographic markets or distribution networks
- Risks associated with acquisitions, dispositions, business partnerships or investments – such as acquisition integration, or termination difficulties or costs, or impairment in recorded value
- Inadequate protection of our intellectual property rights
- Product recalls or other product liability claims; product counterfeiting, tampering, contamination, or product quality issues
- Significant legal disputes and proceedings; government investigations (particularly of industry or company business, trade or marketing practices)

- Failure or breach of key information technology systems
- Negative publicity related to our company, brands, marketing, personnel, operations, business performance, or prospects
- Failure to attract or retain key executive or employee talent
- Our status as a family "controlled company" under New York Stock Exchange rules

Table of Contents

Summary of Operating Performance

	Three months ended October 31,				Six months ended October 31,			
	2014	2015	Reported Change	Underlying Change[1]	2014	2015	Reported Change	Underlying Change[1]
Net sales	$1,135	$1,096	(4)%	5 %	$2,056	$1,995	(3)%	6 %
Excise taxes	258	242	(6)%	7 %	474	444	(6)%	6 %
Cost of sales	268	268	— %	4 %	478	475	(1)%	7 %
Gross profit	609	586	(4)%	4 %	1,104	1,076	(3)%	6 %
Advertising	123	115	(7)%	(1)%	223	209	(6)%	1 %
SG&A	178	171	(4)%	1 %	348	340	(2)%	3 %
Operating income	$303	$302	— %	7 %	$523	$529	1 %	9 %
Gross margin	53.6 %	53.5 %	(0.1)pp		53.7 %	53.9 %	0.2pp	
Operating margin	26.6 %	27.6 %	1.0pp		25.4 %	26.5 %	1.1pp	
Interest expense, net	$7	$12	80 %		$13	$21	58 %	
Effective tax rate	29.9 %	31.0 %	1.1pp		29.9 %	29.9 %	—	
Diluted earnings per share	$0.97	$0.97	— %		$1.67	$1.72	3 %	

[1]See “Non-GAAP Financial Measures” above for details on our use of “underlying changes” for net sales, excise taxes, cost of sales, gross profit, advertising expenses, SG&A expenses, and operating income, including how these measures are calculated and the reasons why we think this information is useful to readers.

Overview

For the three months ended October 31, 2015, compared to same period last year, we grew underlying net sales 5% (reported declined 4%), increased underlying operating income 7% (reported did not change), and delivered the same diluted earnings per share.

For the six months ended October 31, 2015, compared to the same period last year, we grew underlying net sales 6% (reported declined 3%), increased underlying operating income 9% (1% reported), and delivered a 3% increase in diluted earnings per share. These operating results were driven by the continued global net sales growth of our American whiskey portfolio, led by the Jack Daniel's family of brands, including significant contributions from Jack Daniel’s Tennessee Fire (JDTF), and by Woodford Reserve. We improved operating leverage, as underlying advertising and SG&A expenses grew slower than gross profit, driven largely by timing and a cautious spending posture in several markets where economies and consumer purchasing power have weakened. In addition, foreign exchange negatively affected our reported operating income as a result of the strengthening of the dollar against currencies in all markets.

Our financial condition remained strong. We received proceeds of $490 million from the issuance of long-term debt in June 2015, while continuing to invest in our capacity expansion projects and returning $869 million to shareholders during the six months ended October 31, 2015, through dividends and share repurchases.

Table of Contents

RESULTS OF OPERATIONS – FISCAL 2016 YEAR-TO-DATE HIGHLIGHTS

Market Highlights

The following table provides supplemental information for our largest markets for the six months ended October 31, 2015, compared to the same period last year. We discuss results for the markets most affecting our performance below the table. Unless otherwise indicated, all related commentary is for the six months ended October 31, 2015, compared to the same period last year.

Top 10 Markets[1] - Fiscal 2016 Net Sales Growth by Geographic Area

Six months ended October 31, 2015	Percentage change versus prior year period			
	Net Sales[2]			
Geographic area	Reported	Foreign Exchange	Net Chg in Est. Distributor Inventories	Underlying *
United States	5 %	— %	2 %	7 %
Europe	(5 %)	13 %	— %	8 %
United Kingdom	1 %	4 %	— %	4 %
Germany	5 %	12 %	— %	17 %
Poland	(12 %)	17 %	— %	5 %
France	3 %	11 %	— %	14 %