MCDONALDS CORP
Form 10-Q
May 08, 2018

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2018
OR
¨ **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 1-5231

McDONALD'S CORPORATION
(Exact Name of Registrant as Specified in Its Charter)

Delaware	**36-2361282**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
One McDonald's Plaza Oak Brook, Illinois	**60523**
(Address of Principal Executive Offices)	(Zip Code)

(630) 623-3000
(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 x 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 x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨ (do not check if a smaller reporting company)	Smaller reporting company ¨
Emerging growth company ¨	

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

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

785,177,398

(Number of shares of common stock outstanding as of March 31, 2018)

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McDONALD’S CORPORATION

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PART I – FINANCIAL INFORMATION
Item 1. Financial Statements
CONDENSED CONSOLIDATED BALANCE SHEET

In millions, except per share data	(unaudited) March 31, 2018	December 31, 2017
Assets		
Current assets		
Cash and equivalents	**$ 2,468.0**	$ 2,463.8
Accounts and notes receivable	**1,951.6**	1,976.2
Inventories, at cost, not in excess of market	**53.8**	58.8
Prepaid expenses and other current assets	**435.9**	828.4
Total current assets	**4,909.3**	5,327.2
Other assets		
Investments in and advances to affiliates	**1,147.4**	1,085.7
Goodwill	**2,404.8**	2,379.7
Miscellaneous	**2,557.4**	2,562.8
Total other assets	**6,109.6**	6,028.2
Property and equipment		
Property and equipment, at cost	**37,164.7**	36,626.4
Accumulated depreciation and amortization	**(14,460.7)**	(14,178.1)
Net property and equipment	**22,704.0**	22,448.3
Total assets	**$ 33,722.9**	$ 33,803.7
Liabilities and shareholders' equity		
Current liabilities		
Accounts payable	**$ 779.9**	$ 924.8
Income taxes	**462.0**	265.8
Other taxes	**308.7**	275.4
Accrued interest	**280.7**	278.4
Accrued payroll and other liabilities	**990.1**	1,146.2
Total current liabilities	**2,821.4**	2,890.6
Long-term debt	**30,869.5**	29,536.4
Long-term income taxes	**2,009.5**	2,370.9
Deferred revenues - initial franchise fees	**607.4**	—
Other long-term liabilities	**1,154.0**	1,154.4
Deferred income taxes	**979.9**	1,119.4
Shareholders' equity (deficit)		
Preferred stock, no par value; authorized – 165.0 million shares; issued – none	**—**	—
Common stock, $.01 par value; authorized – 3.5 billion shares; issued – 1,660.6 million shares	**16.6**	16.6
Additional paid-in capital	**7,122.2**	7,072.4
Retained earnings	**48,396.5**	48,325.8
Accumulated other comprehensive income (loss)	**(2,146.5)**	(2,178.4)
Common stock in treasury, at cost; 875.4 and 866.5 million shares	**(58,107.6)**	(56,504.4)
Total shareholders' equity (deficit)	**(4,718.8)**	(3,268.0)
Total liabilities and shareholders' equity (deficit)	**$ 33,722.9**	$ 33,803.7

See Notes to condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENT OF INCOME (UNAUDITED)

In millions, except per share data	Quarters Ended March 31, 2018	2017
Revenues		
Sales by Company-operated restaurants	**$2,535.6**	$3,411.9
Revenues from franchised restaurants	**2,603.3**	2,264.0
Total revenues	**5,138.9**	5,675.9
Operating costs and expenses		
Company-operated restaurant expenses	**2,130.9**	2,816.4
Franchised restaurants-occupancy expenses	**480.3**	430.1
Selling, general & administrative expenses	**533.1**	521.3
Other operating (income) expense, net	**(148.5)**	(125.9)
Total operating costs and expenses	**2,995.8**	3,641.9
Operating income	**2,143.1**	2,034.0
Interest expense	**236.8**	218.6
Nonoperating (income) expense, net	**18.4**	7.9
Income before provision for income taxes	**1,887.9**	1,807.5
Provision for income taxes	**512.5**	592.7
Net income	**$1,375.4**	$1,214.8
Earnings per common share-basic	**$1.74**	$1.48
Earnings per common share-diluted	**$1.72**	$1.47
Dividends declared per common share	**$1.01**	$0.94
Weighted-average shares outstanding-basic	**790.9**	818.8
Weighted-average shares outstanding-diluted	**798.7**	825.2

See Notes to condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (UNAUDITED)

In millions	Quarters Ended March 31, 2018	2017
Net income	**$1,375.4**	$1,214.8
Other comprehensive income (loss), net of tax		
Foreign currency translation adjustments:		
Gain (loss) recognized in accumulated other comprehensive income (AOCI), including net investment hedges	**25.7**	287.6
Reclassification of (gain) loss to net income	**—**	109.0
Foreign currency translation adjustments-net of tax benefit (expense) of $72.3 and $44.5	**25.7**	396.6
Cash flow hedges:		
Gain (loss) recognized in AOCI	**(7.5)**	(7.1)
Reclassification of (gain) loss to net income	**12.0**	(3.9)
Cash flow hedges-net of tax benefit (expense) of $(1.2) and $6.2	**4.5**	(11.0)
Defined benefit pension plans:		
Gain (loss) recognized in AOCI	**(1.1)**	(0.3)
Reclassification of (gain) loss to net income	**2.8**	2.6
Defined benefit pension plans-net of tax benefit (expense) of $(0.9) and $(0.5)	**1.7**	2.3
Total other comprehensive income (loss), net of tax	**31.9**	387.9
Comprehensive income (loss)	**$1,407.3**	$1,602.7

See Notes to condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

In millions	Quarters Ended March 31, 2018	2017
Operating activities		
Net income	**$1,375.4**	$1,214.8
Adjustments to reconcile to cash provided by operations		
Charges and credits:		
Depreciation and amortization	**362.9**	325.3
Deferred income taxes	**29.2**	85.9
Share-based compensation	**39.8**	22.7
Other	**(54.9)**	(112.7)
Changes in working capital items	**(107.2)**	8.0
Cash provided by operations	**1,645.2**	1,544.0
Investing activities		
Capital expenditures	**(552.8)**	(427.7)
Purchases of restaurant businesses	**(23.7)**	(3.1)
Sales of restaurant businesses	**186.7**	545.8
Sales of property	**71.7**	65.3
Other	**(41.0)**	(42.2)
Cash provided by (used for) investing activities	**(359.1)**	138.1
Financing activities		
Net short-term borrowings	**556.0**	(769.2)
Long-term financing issuances	**1,499.7**	1,993.0
Long-term financing repayments	**(1,001.6)**	(402.1)
Treasury stock purchases	**(1,632.9)**	(748.0)
Common stock dividends	**(797.5)**	(770.6)
Proceeds from stock option exercises	**75.3**	116.2
Other	**(5.2)**	(6.5)
Cash used for financing activities	**(1,306.2)**	(587.2)
Effect of exchange rates on cash and cash equivalents	**24.3**	54.7
Cash and equivalents increase	**4.2**	1,149.6
Change in cash balances of businesses held for sale	—	39.2
Cash and equivalents at beginning of period	**2,463.8**	1,223.4
Cash and equivalents at end of period	**$2,468.0**	$2,412.2

See Notes to condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY (UNAUDITED)

	Common stock issued				*Accumulated other comprehensive income (loss)*			*Common stock in treasury*		
In millions, except per share data	*Shares*	*Amount*	*Additional paid-in capital*	*Retained earnings*	*Pensions*	*Cash flow hedges*	*Foreign currency translation*	*Shares*	*Amount*	*Total shareholders' equity*
Balance at December 31, 2017	1,660.6	$ 16.6	$ 7,072.4	$ 48,325.8	$ (190.2)	$ (16.5)	$ (1,971.7)	(866.5)	$ (56,504.4)	$ (3,268.0)
Net income				1,375.4						1,375.4
Other comprehensive income (loss), net of tax					1.7	4.5	25.7			31.9
Comprehensive income										1,407.3
Adoption of ASC 606 [1]				(450.2)						(450.2)
Adoption of ASU 2016-16 [2]				(57.0)						(57.0)
Common stock cash dividends ($1.01 per share)				(797.5)						(797.5)
Treasury stock purchases								(10.4)	(1,666.8)	(1,666.8)
Share-based compensation			39.8							39.8
Stock option exercises and other			10.0					1.5	63.6	73.6
Balance at March 31, 2018	1,660.6	16.6	7,122.2	48,396.5	(188.5)	(12.0)	(1,946.0)	(875.4)	(58,107.6)	(4,718.8)

(1) Accounting Standards Codification ("ASC") 606, "Revenue Recognition - Revenue from Contracts with Customers." Refer to the ***Recent Accounting Pronouncements*** footnote on page 8 for further details.
(2) Accounting Standards Update ("ASU") 2016-16, "Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory." Refer to the ***Recent Accounting Pronouncements*** footnote on page 8 for further details.

See Notes to condensed consolidated financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Basis of Presentation

The accompanying condensed consolidated financial statements should be read in conjunction with the consolidated financial statements contained in the Company’s December 31, 2017 Annual Report on Form 10-K. In the opinion of management, all adjustments (consisting of normal recurring accruals) necessary for a fair presentation have been included. The results for the quarter ended March 31, 2018, do not necessarily indicate the results that may be expected for the full year.

Restaurant Information

The following table presents restaurant information by ownership type:

Restaurants at March 31,	**2018**	2017
Conventional franchised	**21,425**	21,168
Developmental licensed	**6,972**	6,800
Foreign affiliated	**5,882**	3,360
Total Franchised	**34,279**	31,328
Company-operated	**3,007**	5,577
Systemwide restaurants	**37,286**	36,905

The results of operations of restaurant businesses purchased and sold in transactions with franchisees were not material either individually or in the aggregate to the condensed consolidated financial statements for the periods prior to purchase and sale.

Per Common Share Information

Diluted earnings per common share is calculated using net income divided by diluted weighted-average shares. Diluted weighted-average shares include weighted-average shares outstanding plus the dilutive effect of share-based compensation, calculated using the treasury stock method, of 7.8 million shares and 6.4 million shares for the first quarter 2018 and 2017, respectively. Stock options that would have been antidilutive, and therefore were not included in the calculation of diluted weighted-average shares, totaled 2.5 million shares and 4.6 million shares for the first quarter 2018 and 2017, respectively.

Recent Accounting Pronouncements

Recently Issued Accounting Standards

Measurement Period - Tax Cuts and Jobs Act of 2017

In December 2017, the Securities and Exchange Commission published Staff Accounting Bulletin No. 118 ("SAB 118"), which provides guidance on reporting for accounting impacts of the Tax Cuts and Jobs Act of 2017 (“Tax Act”). SAB 118 allowed the Company to provide reasonable estimates in its 2017 consolidated financial statements for the income tax effects of the Tax Act and to report those effects as provisional amounts in its financial statements through a limited measurement period. Under SAB 118, the measurement period may not extend beyond one year from the enactment of the Tax Act.

The Company has not completed the accounting for the tax effects of the enactment of the Tax Act, although it has made reasonable estimates of the effects on existing deferred tax balances and on the one-time transition tax on earnings of certain foreign subsidiaries. A net provisional tax cost of approximately $700 million was originally recognized in the Company's 2017 consolidated financial statements, and subsequently increased by $52 million in the first quarter of 2018.

Lease Accounting

In February 2016, the FASB issued ASU 2016-02, “Leases (Topic 842),” to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. Most prominent among the amendments is the recognition of assets and liabilities by lessees for those leases classified as operating leases under current U.S. GAAP. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, with early adoption permitted. The Company will adopt the new standard effective January 1, 2019.

At transition, the Company will recognize and measure leases using the required modified retrospective approach. The Company anticipates ASU 2016-02 will have a material impact to the consolidated balance sheet due to the significance of the Company’s operating lease portfolio. The Company will elect an optional practical expedient to retain the current classification of leases, and, therefore, anticipates a minimal initial impact on the consolidated statement of income. The impact of ASU 2016-02 is non-cash in nature; therefore, it will not affect the Company’s cash flows.

Recently Adopted Accounting Standards

Derivatives and Hedging

In August 2017, the FASB issued ASU 2017-12, “Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities.” ASU 2017-12 expands components of fair value hedging, specifies the recognition and presentation of the effects of hedging instruments, and eliminates the separate measurement and presentation of hedge ineffectiveness. The Company elected to early adopt the new standard in the first quarter of 2018 and applied the presentation and disclosure guidance on a prospective basis. The adoption of the new standard did not have a material impact on the Company's condensed consolidated financial statements.

Income Taxes

In October 2016, the FASB issued ASU 2016-16, “Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory.” The goal of this update is to improve the accounting for the income tax consequences of intra-entity transfers of assets other than inventory. The Company adopted this standard on January 1, 2018 using a modified retrospective method, resulting in a cumulative catch up adjustment of $57 million, the majority of which was recorded within miscellaneous other assets on the condensed consolidated balance sheet. The adoption of this standard does not have a material impact on the condensed consolidated statements of income and cash flows.

Revenue Recognition

In May 2014, the FASB issued guidance codified in Accounting Standards Codification ("ASC") 606, "Revenue Recognition - Revenue from Contracts with Customers," which amends the guidance in former ASC 605, "Revenue Recognition." The core principle of the standard is to recognize revenue when control of the promised goods or services is transferred to customers in an amount that reflects the consideration expected to be received for those goods or services. The standard also requires additional disclosures around the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

On January 1, 2018, the Company adopted ASC 606 using the modified retrospective method. Refer to the ***Revenues*** footnote below for further details.

Revenues

The Company’s revenues consist of sales by Company-operated restaurants and fees from franchised restaurants operated by conventional franchisees, developmental licensees and foreign affiliates. Revenues from conventional franchised restaurants include rent and royalties based on a percent of sales with minimum rent payments, and initial fees. Revenues from restaurants licensed to foreign affiliates and developmental licensees include a royalty based on a percent of sales, and may include initial fees.

ASC 606 provides that revenues are to be recognized when control of promised goods or services is transferred to a customer in an amount that reflects the consideration expected to be received for those goods or services. This new standard does not impact the Company's recognition of revenue from Company-operated restaurants as those sales are recognized on a cash basis at the time of the underlying sale and are presented net of sales tax and other sales-related taxes. The standard also does not change the recognition of royalties from restaurants operated by franchisees or licensed to affiliates and developmental licensees, which are based on a percent of sales and recognized at the time the underlying sales occur. Rental income from restaurants operated by conventional franchisees is also not impacted by this new standard as those revenues are subject to the guidance in ASC 840, "Leases." The standard does change the timing in which the Company recognizes initial fees from franchisees for new restaurant openings and new franchise terms. The Company's accounting policy through December 31, 2017, was to recognize initial franchise fees when received, upon new restaurant opening and at the start of a new franchise term. Beginning in January 2018, initial franchise fees are being recognized as the Company satisfies the performance obligation over the franchise term, which is generally 20 years.

The Company adopted ASC 606 as of January 1, 2018, using the modified retrospective method. This method allows the new standard to be applied retrospectively through a cumulative catch up adjustment recognized upon adoption. As such, comparative information in the Company’s financial statements has not been restated and continues to be reported under the accounting standards in effect for those periods. The cumulative adjustment recorded upon adoption of ASC 606 consisted of deferred revenue of approximately $600 million within long-term liabilities and approximately $150 million of associated adjustments to the deferred tax balances which are recorded in Deferred income taxes and Miscellaneous other assets on the condensed consolidated balance sheet.

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The following table presents revenue disaggregated by revenue source (in millions):

Quarters Ended March 31,	**2018**	2017
Company-operated sales		
U.S.	**$708.7**	$835.6
International Lead Markets	**1,007.1**	941.2
High Growth Markets	**700.3**	1,345.3
Foundational Markets & Corporate	**119.5**	289.8
Total	**$2,535.6**	$3,411.9
Franchised revenues		
U.S.	**$1,158.5**	$1,093.4
International Lead Markets	**870.4**	702.3
High Growth Markets	**271.9**	191.9
Foundational Markets & Corporate	**302.5**	276.4
Total*	**$2,603.3**	$2,264.0
Total revenues		
U.S.	**$1,867.2**	$1,929.0
International Lead Markets	**1,877.5**	1,643.5
High Growth Markets	**972.2**	1,537.2
Foundational Markets & Corporate	**422.0**	566.2
Total	**$5,138.9**	$5,675.9

* Although the Company expects the application of ASC 606 to negatively impact 2018 annual franchised revenues by approximately $50 million, results for the quarter ended March 31, 2018, only reflected an impact of approximately $5 million due to the timing of new restaurant openings and new franchise terms.

Fair Value Measurements

The Company measures certain financial assets and liabilities at fair value. Fair value disclosures are reflected in a three-level hierarchy, maximizing the use of observable inputs and minimizing the use of unobservable inputs. The Company did not have any significant changes to the valuation techniques used to measure fair value as described in the Company's December 31, 2017 Annual Report on Form 10-K.

At March 31, 2018, the fair value of the Company’s debt obligations was estimated at $32.5 billion, compared to a carrying amount of $30.9 billion. The fair value was based upon quoted market prices, Level 2 within the valuation hierarchy. The carrying amounts of cash and equivalents, short-term investments and notes receivable approximate fair value.

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Financial Instruments and Hedging Activities

The Company is exposed to global market risks, including the effect of changes in interest rates and foreign currency fluctuations. The Company uses foreign currency denominated debt and derivative instruments to mitigate the impact of these changes. The Company does not hold or issue derivatives for trading purposes.

The following table presents the fair values of derivative instruments included on the condensed consolidated balance sheet:

	Derivative Assets			**Derivative Liabilities**		
In millions	Balance Sheet Classification	**March 31, 2018**	December 31, 2017	Balance Sheet Classification	**March 31, 2018**	December 31, 2017
Derivatives designated as hedging instruments						
Foreign currency	Prepaid expenses and other current assets	**$ 2.9**	$ 0.5	Accrued payroll and other liabilities	**$ (29.0)**	$ (31.0)
Interest Rate				Accrued payroll and other liabilities	**(1.0)**	(0.3)
Foreign currency	Miscellaneous other assets	**0.8**	0.1	Other long-term liabilities	**(0.9)**	(1.4)
Interest rate				Other long-term liabilities	**(17.5)**	(5.9)
Total derivatives designated as hedging instruments		**$ 3.7**	$ 0.6		**$ (48.4)**	$ (38.6)
Derivatives not designated as hedging instruments						
Equity				Accrued payroll and other liabilities	**$ (5.2)**	$ (1.3)
Foreign currency				Accrued payroll and other liabilities	**(2.1)**	(5.5)
Equity	Miscellaneous other assets	**$ 152.3**	$ 167.3			
Total derivatives not designated as hedging instruments		**$ 152.3**	$ 167.3		**$ (7.3)**	$ (6.8)
Total derivatives		**$ 156.0**	$ 167.9		**$ (55.7)**	$ (45.4)

The following table presents the pre-tax amounts from derivative instruments affecting income and other comprehensive income ("OCI") for the quarters ended March 31, 2018 and 2017, respectively:

	Location of Gain or Loss Recognized in Income on Derivative	**Gain (Loss) Recognized in Accumulated OCI**	**Gain (Loss) Reclassified into Income from Accumulated OCI**	**Gain (Loss) Recognized in Income on Derivative**
In millions				