UNIVERSAL CORP /VA/
Form 10-Q
November 05, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2013
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 Number: 001-00652

UNIVERSAL CORPORATION
(Exact name of registrant as specified in its charter)

Virginia (State or other jurisdiction of incorporation or organization)	54-0414210 (I.R.S. Employer Identification Number)
9201 Forest Hill Avenue, Richmond, Virginia (Address of principal executive offices)	23235 (Zip Code)

804-359-9311
(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 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 definitions of “large accelerated filer,” “accelerated filer,” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer þ Accelerated filer o Non-accelerated filer o 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
As of October 30, 2013, the total number of shares of common stock outstanding was 23,215,946.

UNIVERSAL CORPORATION
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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

UNIVERSAL CORPORATION
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
(in thousands of dollars, except per share data)

	Three Months Ended September 30,		Six Months Ended September 30,	
	2013	2012	2013	2012
	(Unaudited)		(Unaudited)	
Sales and other operating revenues	$650,869	$675,187	$1,084,397	$1,136,578
Costs and expenses				
Cost of goods sold	531,557	537,138	893,617	906,499
Selling, general and administrative expenses	68,455	59,275	135,074	108,478
Other income	—	—	(81,619)	—
Restructuring costs	1,308	3,687	1,308	3,687
Operating income	49,549	75,087	136,017	117,914
Equity in pretax earnings (loss) of unconsolidated affiliates	(1,563)	(320)	(34)	1,049
Interest income	143	70	404	227
Interest expense	6,160	5,938	11,466	12,108
Income before income taxes	41,969	68,899	124,921	107,082
Income taxes	12,139	19,613	41,178	32,563
Net income	29,830	49,286	83,743	74,519
Less: net (income) loss attributable to noncontrolling interests in subsidiaries	(4,386)	(1,305)	10	(3,413)
Net income attributable to Universal Corporation	25,444	47,981	83,753	71,106
Dividends on Universal Corporation convertible perpetual preferred stock	(3,713)	(3,713)	(7,425)	(7,425)
Earnings available to Universal Corporation common shareholders	$21,731	$44,268	$76,328	$63,681
Earnings per share attributable to Universal Corporation common shareholders:				
Basic	$0.94	$1.89	$3.28	$2.73
Diluted	$0.90	$1.68	$2.95	$2.50
Weighted average common shares outstanding:				
Basic	23,207	23,379	23,262	23,338
Diluted	28,336	28,501	28,401	28,446
Total comprehensive income, net of income taxes	$61,024	$57,704	$116,441	$73,158
Less: comprehensive (income) loss attributable to noncontrolling interests, net of income taxes	(4,375)	(1,407)	347	(3,604)
Comprehensive income attributable to Universal Corporation, net of income taxes	$56,649	$56,297	$116,788	$69,554
Dividends declared per common share	$0.50	$0.49	$1.00	$0.98

See accompanying notes.

UNIVERSAL CORPORATION
CONSOLIDATED BALANCE SHEETS
(in thousands of dollars)

	September 30, 2013 (Unaudited)	September 30, 2012 (Unaudited)	March 31, 2013
ASSETS			
Current assets			
Cash and cash equivalents	$74,631	$115,690	$367,864
Accounts receivable, net	365,777	352,745	401,747
Advances to suppliers, net	62,013	80,946	132,100
Accounts receivable—unconsolidated affiliates	70,175	69,872	555
Inventories—at lower of cost or market:			
Tobacco	1,037,320	901,154	623,377
Other	80,651	70,099	57,745
Prepaid income taxes	28,004	16,889	6,245
Deferred income taxes	30,751	43,986	32,127
Other current assets	130,721	72,100	124,213
Total current assets	1,880,043	1,723,481	1,745,973
Property, plant and equipment			
Land	17,231	17,098	17,125
Buildings	237,923	230,898	234,694
Machinery and equipment	563,615	548,953	545,478
	818,769	796,949	797,297
Less: accumulated depreciation	(530,038)	(498,470)	(509,829)
	288,731	298,479	287,468
Other assets			
Goodwill and other intangibles	99,648	99,145	99,048
Investments in unconsolidated affiliates	99,362	91,024	94,405
Deferred income taxes	28,026	21,808	23,783
Other noncurrent assets	87,748	51,262	55,478
	314,784	263,239	272,714
Total assets	$2,483,558	$2,285,199	$2,306,155

See accompanying notes.

UNIVERSAL CORPORATION
CONSOLIDATED BALANCE SHEETS
(in thousands of dollars)

	September 30, 2013 (Unaudited)	September 30, 2012 (Unaudited)	March 31, 2013
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current liabilities			
Notes payable and overdrafts	$194,266	$93,646	$105,318
Accounts payable and accrued expenses	222,226	187,957	225,648
Accounts payable—unconsolidated affiliates	8	233	4,739
Customer advances and deposits	92,871	47,809	24,914
Accrued compensation	22,152	23,654	36,694
Income taxes payable	14,694	15,869	14,034
Current portion of long-term obligations	213,750	8,750	211,250
Total current liabilities	759,967	377,918	622,597
Long-term obligations	173,750	387,500	181,250
Pensions and other postretirement benefits	95,098	140,085	135,629
Other long-term liabilities	35,911	86,221	36,838
Deferred income taxes	59,373	45,517	42,184
Total liabilities	1,124,099	1,037,241	1,018,498
Shareholders' equity			
Universal Corporation:			
Preferred stock:			
Series A Junior Participating Preferred Stock, no par value, 500,000 shares authorized, none issued or outstanding	—	—	—
Series B 6.75% Convertible Perpetual Preferred Stock, no par value, 220,000 shares authorized, 219,999 shares issued and outstanding (219,999 at September 30, 2012 and March 31, 2013)	213,023	213,023	213,023
Common stock, no par value, 100,000,000 shares authorized, 23,215,946 shares issued and outstanding (23,408,445 at September 30, 2012, and 23,343,973 at March 31, 2013)	202,844	197,435	202,579
Retained earnings	959,242	895,107	918,509
Accumulated other comprehensive loss	(42,505)	(81,913)	(75,540)
Total Universal Corporation shareholders' equity	1,332,604	1,223,652	1,258,571
Noncontrolling interests in subsidiaries	26,855	24,306	29,086
Total shareholders' equity	1,359,459	1,247,958	1,287,657
Total liabilities and shareholders' equity	$2,483,558	$2,285,199	$2,306,155

See accompanying notes.

UNIVERSAL CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands of dollars)

	Six Months Ended September 30, 2013 (Unaudited)	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$83,743	$74,519
Adjustments to reconcile net income to net cash used by operating activities:		
Depreciation	20,034	21,643
Amortization	835	859
Provision for losses on advances and guaranteed loans to suppliers	3,556	4,015
Foreign currency remeasurement loss (gain), net	7,009	(10,395)
Gain on favorable outcome of excise tax case in Brazil	(81,619)	—
Restructuring costs	1,308	3,687
Other, net	2,421	11,547
Changes in operating assets and liabilities, net	(344,433)	(160,643)
Net cash used by operating activities	(307,146)	(54,768)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property, plant and equipment	(19,772)	(19,503)
Proceeds from sale of property, plant and equipment	334	2,232
Net cash used by investing activities	(19,438)	(17,271)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Issuance (repayment) of short-term debt, net	85,150	(29,753)
Repayment of long-term obligations	(5,000)	(12,500)
Dividends paid to noncontrolling interests	(1,884)	(1,837)
Issuance of common stock	457	493
Repurchase of common stock	(14,145)	—
Dividends paid on convertible perpetual preferred stock	(7,425)	(7,425)
Dividends paid on common stock	(23,272)	(22,846)
Net cash provided (used) by financing activities	33,881	(73,868)
Effect of exchange rate changes on cash	(530)	(102)
Net decrease in cash and cash equivalents	(293,233)	(146,009)
Cash and cash equivalents at beginning of year	367,864	261,699
Cash and cash equivalents at end of period	$74,631	$115,690

See accompanying notes.

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UNIVERSAL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION

Universal Corporation, with its subsidiaries ("Universal" or the "Company"), is the leading global leaf tobacco merchant and processor. Because of the seasonal nature of the Company's business, the results of operations for any fiscal quarter will not necessarily be indicative of results to be expected for other quarters or a full fiscal year. All adjustments necessary to state fairly the results for the period have been included and were of a normal recurring nature. Certain amounts in prior year statements have been reclassified to conform to the current year presentation. This Form 10-Q should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2013.

NOTE 2. ACCOUNTING PRONOUNCEMENTS

Effective April 1, 2013, Universal adopted Financial Accounting Standards Board Accounting Standards Update 2013-02, "Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income." The new guidance required companies to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income unless the amounts are not reclassified in their entirety to net income. For amounts that are not reclassified in their entirety to net income in the same reporting period, entities are required to cross-reference other disclosures that provide additional detail about those amounts. Since the new guidance requires additional disclosures only, it did not have any impact on the Company's results of operations, cash flows, or financial position.

NOTE 3. GUARANTEES, OTHER CONTINGENT LIABILITIES, AND OTHER MATTERS

Guarantees and Other Contingent Liabilities

Guarantees of Bank Loans and Other Contingent Liabilities

Guarantees of bank loans to tobacco growers for crop financing and construction of curing barns or other tobacco producing assets have long been industry practice in Brazil and support the farmers' production of tobacco there. More recently, similar arrangements were established in Malawi in connection with a shift from auction market sourcing to direct procurement in that country. At September 30, 2013, the Company's total exposure under guarantees issued by its operating subsidiaries for banking facilities of farmers in Brazil and Malawi was approximately $42 million ($46 million face amount including unpaid accrued interest less $4 million recorded for the fair value of the guarantees). All of the outstanding guarantees expire within one year. The subsidiaries withhold payments due to the farmers on delivery of tobacco and forward those payments to the third-party banks. Failure of farmers to deliver sufficient quantities of tobacco to the subsidiaries to cover their obligations to the third-party banks could result in a liability for the subsidiaries under the related guarantees; however, in that case, the subsidiaries would have recourse against the farmers. The maximum potential amount of future payments that the Company's subsidiaries could be required to make at September 30, 2013, was the face amount, $46 million including unpaid accrued interest ($16 million at September 30, 2012, and $20 million at March 31, 2013). The fair value of the guarantees was a liability of approximately $4 million at September 30, 2013 ($2 million at September 30, 2012, and $4 million at March 31, 2013). In addition to these guarantees, the Company has other contingent liabilities totaling approximately $3 million at September 30, 2013.

European Commission Fines in Italy

In 2002, the Company reported that it was aware that the European Commission (the "Commission") was investigating certain aspects of the leaf tobacco markets in Italy. One of the Company's subsidiaries, Deltafina, S.p.A. ("Deltafina"), buys and processes tobacco in Italy. The Company reported that it did not believe that the Commission investigation in Italy would result in penalties being assessed against it or its subsidiaries that would be material to the Company’s earnings. The reason the Company held this belief was that it had received conditional immunity from the Commission because Deltafina had voluntarily informed the Commission of the activities that were the basis of the investigation.

On December 28, 2004, the Company received a preliminary indication that the Commission intended to revoke Deltafina’s immunity for disclosing in April 2002 that it had applied for immunity. Neither the Commission’s Leniency Notice of February 19, 2002, nor Deltafina’s letter of provisional immunity, contains a specific requirement of confidentiality. The potential for such disclosure was discussed with the Commission in March 2002, and the Commission never told Deltafina that disclosure would affect Deltafina’s immunity. On November 15, 2005, the Company received notification from the Commission that the Commission had imposed fines totaling €30 million on Deltafina and the Company jointly for infringing European Union antitrust law in connection with the purchase and processing of tobacco in the Italian raw tobacco market. In January 2006, the Company and Deltafina each

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filed appeals in the General Court of the European Union ("General Court"). Deltafina’s appeal was held on September 28, 2010. For strategic reasons related to the defense of the Deltafina appeal, Universal withdrew its appeal. On September 9, 2011, the General Court issued its decision, in which it rejected Deltafina’s application to reinstate immunity. Deltafina appealed the decision of the General Court to the European Court of Justice, and a hearing was held in November 2012. Effective with the September 9, 2011 General Court decision, the Company recorded a charge for the full amount of the fine (€30 million) plus accumulated interest (€5.9 million). The charge totaled $49.1 million at the exchange rate in effect on the date of the General Court decision. Deltafina maintains a bank guarantee in favor of the Commission in the amount of the fine plus accumulated interest in order to stay execution during the appeals process, and the Company has collateralized that guarantee with a bank deposit totaling $52 million at September 30, 2013. At September 30, 2013, the accrued liability for the fine and interest was reported in other current liabilities, and the deposit was recorded in other current assets. The Company expects the appeal to be decided during fiscal year 2014. Any fine and interest Deltafina may ultimately be required to pay would not be due until the European Court of Justice issues its decision.

Other Legal and Tax Matters

In addition to the above-mentioned matter, various subsidiaries of the Company are involved in other litigation and tax examinations incidental to their business activities. While the outcome of these matters cannot be predicted with certainty, management is vigorously defending the matters and does not currently expect that any of them will have a material adverse effect on the Company’s business or financial position. However, should one or more of these matters be resolved in a manner adverse to management’s current expectation, the effect on the Company’s results of operations for a particular fiscal reporting period could be material.

Favorable Outcome of IPI Tax Credit Case in Brazil

During the quarter ended June 30, 2013, a longstanding lawsuit related to IPI tax credits filed by the Company's operating subsidiary in Brazil was concluded in the subsidiary's favor with a decision by the Brazilian Superior Court of Justice on the final appeal filed by the Brazilian federal government. Although additional appeals by the government were expected in the case, the time period to file those appeals expired before the end of the quarter, and the decision and overall outcome of the case have been confirmed.

IPI tax credits were established under Brazilian tax laws to allow recovery of a portion of the excise taxes paid on manufactured products when those products are sold in export markets. In prior years, the subsidiary paid excise taxes on the component cost of unprocessed tobacco purchased from growers, as well as the cost of electricity, packing materials, and other inputs used in its manufacturing process. Under the law, the subsidiary believed it was entitled to use IPI tax credits to recover excise taxes on the processed tobacco it exported. However, specific regulations issued by the Brazilian tax authorities did not permit the subsidiary to claim those credits. The suit filed by the subsidiary challenged the denial of the tax credits based on the law. Several decisions in lower courts were decided in the subsidiary's favor for a portion of the tax credits claimed in the suit, but those decisions were appealed on various grounds by both the government and the subsidiary. The expiration of the latest appeal period ended the matter in the courts.

The final court decision entitles the subsidiary to approximately $104 million of IPI tax credits (based on the exchange rate at September 30, 2013), which it can use to offset future payments of other Brazilian federal taxes for a period of up to five years. This amount includes the tax credits generated over the period granted by the courts, as well as interest calculated from the date those credits should have been available to the subsidiary. As noted, the ability to use the tax credits to offset other Brazilian federal tax payments expires in five years, and utilization of the credits is also subject to audit by the tax authorities. Based on current estimates of the tax credits that are probable of being realized, the subsidiary has recorded an allowance, reducing the net book value of the credits to approximately $90 million. After deducting related legal fees and Brazilian social contribution taxes assessed on the interest portion of the total

IPI tax credits received, the subsidiary recorded a net gain of $81.6 million ($53.1 million after tax, or $1.96 per diluted share) during the quarter ended June 30, 2013, as a result of the favorable outcome of the case. The gain is reported in Other Income in the consolidated statement of income. Management of the Company and the subsidiary regularly review the estimates and assumptions used in determining the total amount of the tax credits likely to be realized and, accordingly, it is reasonably possible that the valuation allowance could be adjusted in future reporting periods.

Advances to Suppliers

In many sourcing origins where the Company operates, it provides agronomy services and seasonal advances of seed, fertilizer, and other supplies to tobacco farmers for crop production, or makes seasonal cash advances to farmers for the procurement of those inputs. These advances are short term, are repaid upon delivery of tobacco to the Company, and are reported in advances to suppliers in the consolidated balance sheets. In several origins, the Company has made long-term advances to tobacco farmers to finance curing barns and other farm infrastructure. In some years, due to low crop yields and other factors, individual farmers may not deliver sufficient volumes of tobacco to fully repay their seasonal advances, and the Company may extend repayment of those advances into the following crop year. The long-term portion of advances is included in other noncurrent assets in the consolidated balance sheets. Both the current and the long-term portions of advances to suppliers are reported net of allowances recorded when the Company determines that amounts outstanding are not likely to be collected. Short-term and long-term advances to suppliers totaled $110 million at September 30, 2013, $152 million at September 30, 2012, and $199 million at March 31, 2013. The related valuation allowances totaled $42 million at September 30, 2013, $63 million at September 30, 2012, and $54 million at March 31, 2013, and were estimated based on the Company's historical loss information and crop projections. The allowances were increased by provisions for estimated uncollectible amounts of approximately $4 million in each of the six-month periods ended September 30, 2013 and 2012, respectively. These provisions are included in selling, general, and administrative expenses in the consolidated statements of income. Interest on advances is recognized in earnings upon the farmers' delivery of tobacco in payment of principal and interest. Accrual of interest is discontinued when an advance is not expected to be fully collected.

Recoverable Value-Added Tax Credits

In many foreign countries, the Company's local operating subsidiaries pay significant amounts of value-added tax ("VAT") on purchases of unprocessed and processed tobacco, crop inputs, packing materials, and various other goods and services. In some countries, VAT is a national tax, and in other countries it is assessed at the state level. Items subject to VAT vary from jurisdiction to jurisdiction, as do the rates at which the tax is assessed. When tobacco is sold to customers in the country of origin, the operating subsidiaries generally collect VAT on those sales. The subsidiaries are normally permitted to offset their VAT payments against the collections and remit only the incremental VAT collections to the tax authorities. When tobacco is sold for export, VAT is normally not assessed. In countries where tobacco sales are predominately for export markets, VAT collections generated on downstream sales are often not sufficient to fully offset the subsidiaries' VAT payments. In those situations, unused VAT credits can accumulate. Some jurisdictions have procedures that allow companies to apply for refunds of unused VAT credits from the tax authorities, but the refund process often takes an extended period of time and it is not uncommon for refund applications to be challenged or rejected in part on technical grounds. Other jurisdictions may permit companies to sell or transfer unused VAT credits to third parties in private transactions, although approval for such transactions must normally be obtained from the tax authorities, limits on the amounts that can be transferred are usually imposed, and the proceeds realized may be heavily discounted from the face value of the credits. Due to these factors, local operating subsidiaries in some countries can accumulate significant balances of VAT credits over time. The Company reviews these balances on a regular basis and records valuation allowances on the credits to reflect amounts that are not expected to be recovered, as well as discounts anticipated on credits that are expected to be sold or transferred. At September 30, 2013, the aggregate balance of recoverable tax credits held by the Company's subsidiaries totaled approximately $70 million ($81 million at September 30, 2012, and $73 million at March 31, 2013), and the related valuation allowances totaled approximately $27 million ($26 million at September 30, 2012, and $26 million at March 31, 2013). The net balances are reported in other current assets and other noncurrent assets in the consolidated balance sheets.

In June 2011, tax authorities in Brazil completed an audit of inter-state VAT filings by the Company's operating subsidiary there and issued assessments for tax, penalties, and interest for tax periods from 2006 through 2009 totaling approximately $21 million based on the exchange rate for the Brazilian currency at September 30, 2013. Management of the operating subsidiary and outside counsel believe that errors were made by the tax authorities in determining portions of the assessment and that various defenses support the subsidiary's positions. Accordingly, the subsidiary took steps to contest the full amount of the assessment. As of September 30, 2013, a portion of the subsidiary's arguments had been accepted, and the outstanding assessments had been reduced to approximately $16 million (at the September 30, 2013 exchange rate). The subsidiary is continuing to contest the full remaining amount of the assessment. While the range of reasonably possible loss is zero up to the full $16 million remaining assessment, based on the strength of the subsidiary's defenses, no loss within that range is considered probable at this time and no liability has been recorded at September 30, 2013.

NOTE 4. RESTRUCTURING COSTS

Universal continually reviews its business for opportunities to realize efficiencies, reduce costs, and realign its operations in response to business changes. In July 2013, the Company's subsidiary in Brazil announced plans to close a factory and centralize all tobacco processing activities in its primary facility. In connection with this initiative, the Company recorded restructuring costs totaling $0.8 million during the quarter ended September 30, 2013, which included employee termination costs, as well as costs to relocate personnel and equipment to the main facility. In addition, during the quarter ended September 30, 2013, the Company recorded $0.5 million of restructuring costs associated with other actions taken in various areas of its worldwide operations. The Company anticipates that all of the restructuring costs will be paid before the end of the current fiscal year. During the first six months of fiscal year 2013, the Company recorded restructuring costs totaling $3.7 million, primarily related to workforce reductions in one of the Company's operations in Africa. Substantially all of the restructuring costs incurred in both fiscal years 2014 and 2013 relate to operations that are part of the Other Regions reportable segment of the Company's flue-cured and burley leaf tobacco operations.

NOTE 5. EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share:

(in thousands, except per share data)	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012	Six Months Ended September 30, 2013	Six Months Ended September 30, 2012
Basic Earnings Per Share				
Numerator for basic earnings per share				
Net income attributable to Universal Corporation	$25,444	$47,981	$83,753	$71,106
Less: Dividends on convertible perpetual preferred stock	(3,713)	(3,713)	(7,425)	(7,425)
Earnings available to Universal Corporation common shareholders for calculation of basic earnings per share	21,731	44,268	76,328	63,681
Denominator for basic earnings per share				
Weighted average shares outstanding	23,207	23,379	23,262	23,338
Basic earnings per share	$0.94	$1.89	$3.28	$2.73
Diluted Earnings Per Share				
Numerator for diluted earnings per share				
Earnings available to Universal Corporation common shareholders	$21,731	$44,268	$76,328	$63,681
Add: Dividends on convertible perpetual preferred stock (if conversion assumed)	3,713	3,713	7,425	7,425
Earnings available to Universal Corporation common shareholders for calculation of diluted earnings per share	25,444	47,981	83,753	71,106
Denominator for diluted earnings per share				
Weighted average shares outstanding	23,207	23,379	23,262	23,338
Effect of dilutive securities (if conversion or exercise assumed)				
Convertible perpetual preferred stock	4,818	4,794	4,815	4,791
Employee share-based awards	311	328	324	317
Denominator for diluted earnings per share	28,336	28,501	28,401	28,446
Diluted earnings per share	$0.90	$1.68	$2.95	$2.50

For the six months ended September 30, 2013 and 2012, the Company had the following potentially dilutive securities (stock appreciation rights and/or stock options) outstanding that were not included in the computation of diluted earnings per share because their effect would have been antidilutive:

	Six Months Ended September 30, 2013	Six Months Ended September 30, 2012
Potentially dilutive securities (shares in thousands)	169	318
Weighted-average exercise price	$62.66	$57.61

NOTE 6. INCOME TAXES

The Company is subject to the tax laws of many jurisdictions. Changes in tax laws or the interpretation of tax laws can affect the Company's earnings, as can the resolution of pending and contested tax issues. The consolidated income tax rate is affected by a number of factors, including the mix of domestic and foreign earnings and investments, local tax rates of subsidiaries, repatriation of foreign earnings, the effect of exchange rate changes on deferred taxes, and the Company's ability to utilize foreign tax credits.

The consolidated effective income tax rate on pretax earnings was approximately 29% and 28% for the quarters ended September 30, 2013 and 2012, respectively, and approximately 33% and 30% for the six months ended September 30, 2013 and 2012, respectively. The effective rate for each of the reporting periods was lower than the 35% U.S. federal statutory rate primarily due to the effect of changes in exchange rates on deferred income tax assets and liabilities of foreign subsidiaries and a lower net effective tax rate on dividend income from unconsolidated operations.

NOTE 7. DERIVATIVES AND HEDGING ACTIVITIES

Universal is exposed to various risks in its worldwide operations and uses derivative financial instruments to manage two specific types of risks – interest rate risk and foreign currency exchange rate risk. Interest rate risk is managed by entering into interest rate swap agreements, and foreign currency exchange rate risk is managed by entering into forward foreign currency exchange contracts. However, the Company’s policy also permits other types of derivative instruments. In addition, foreign currency exchange rate risk is also managed through strategies that do not involve derivative instruments, such as using local borrowings and other approaches to minimize net monetary positions in non-functional currencies. The disclosures below provide additional information about the Company’s hedging strategies, the derivative instruments used, and the effects of these activities on the consolidated statements of income and the consolidated balance sheets. In the consolidated statements of cash flows, the cash flows associated with all of these activities are reported in net cash provided by operating activities.

Hedging Strategy for Interest Rate Risk

The Company has receive-floating/pay-fixed interest rate swap agreements that were designated and qualify as hedges of the exposure to changes in interest payment cash flows created by fluctuations in variable interest rates on its outstanding amortizing bank term loan. Although no significant ineffectiveness is expected with this hedging strategy, the effectiveness of the interest rate swaps is evaluated on a quarterly basis. The aggregate notional amount of the interest rate swaps is being reduced over a five-year period as payments are made on the loan. At September 30, 2013, the total notional amount of the swaps was approximately $88 million, which corresponded with the outstanding balance of the loan.

Cash Flow Hedging Strategy for Foreign Currency Exchange Rate Risk Related to Forecast Purchases of Tobacco and Related Processing Costs

The majority of the tobacco production in most countries outside the United States where Universal operates is sold in export markets at prices denominated in U.S. dollars. However, purchases of tobacco from farmers and most processing costs (such as labor and energy) in those countries are usually denominated in the local currency. Changes in exchange rates between the U.S. dollar and the local currencies where tobacco is grown and processed affect the ultimate U.S. dollar cost of the processed tobacco. From time to time, the Company enters into forward contracts to sell U.S. dollars and buy the local currency at future dates that coincide with the expected timing of a portion of the tobacco purchases and processing costs. This strategy offsets the variability of future U.S. dollar cash flows for tobacco purchases and processing costs for the foreign currency notional amount hedged. This hedging strategy has been used mainly for tobacco purchases and processing costs in Brazil.

The aggregate U.S. dollar notional amount of forward contracts entered for these purposes during the first six months of fiscal years 2014 and 2013, was as follows:

	Six Months Ended September 30,	
(in millions of dollars)	2013	2012
Tobacco purchases	$82.8	$64.3
Processing costs	18.5	13.7
Total	$101.3	$78.0

All contracts related to tobacco purchases were designated and qualify as hedges of the future cash flows associated with the forecast purchases of tobacco. As a result, except for amounts related to any ineffective portion of the hedging strategy, changes in fair values of the forward contracts have been recognized in comprehensive income as they occurred, but only recognized in earnings upon sale of the related tobacco to third-party customers. Forward contracts related to processing costs have not been designated as hedges, and gains and losses on those contracts have been recognized in earnings on a mark-to-market basis.

Purchases of the 2013 crop were completed in August 2013, and all forward contracts to hedge those purchases matured and settled by that time. For substantially all hedge gains and losses recorded in accumulated other comprehensive loss at September 30, 2013, the Company expects to complete the sale of the tobacco and recognize the amounts in earnings during fiscal year 2014.

Hedging Strategy for Foreign Currency Exchange Rate Risk Related to Net Local Currency Monetary Assets and Liabilities of Foreign Subsidiaries

Most of the Company’s foreign subsidiaries transact the majority of their sales in U.S. dollars and finance the majority of their operating requirements with U.S. dollar borrowings, and therefore use the U.S. dollar as their functional currency. These subsidiaries normally have certain monetary assets and liabilities on their balance sheets that are denominated in the local currency. Those assets and liabilities can include cash and cash equivalents, accounts receivable and accounts payable, advances to farmers and suppliers, deferred income tax assets and liabilities, recoverable value-added taxes, and other items. Net monetary assets and liabilities denominated in the local currency are remeasured into U.S. dollars each reporting period, generating gains and losses that the Company records in earnings as a component of selling, general, and administrative expenses. The level of net monetary assets or liabilities denominated in the local currency normally fluctuates throughout the year based on the operating cycle, but it is most common for monetary assets to exceed monetary liabilities, sometimes by a significant amount. When this situation exists and the local currency weakens against the U.S. dollar, remeasurement losses are generated. Conversely, remeasurement gains are generated on a net monetary asset position when the local currency strengthens against the U.S. dollar. To further mitigate currency remeasurement exposure, the Company’s foreign subsidiaries may utilize short-term local currency financing during certain periods. This strategy, while not involving the use of derivative instruments, is intended to minimize the subsidiary’s net monetary position by financing a portion of the local currency monetary assets with local currency monetary liabilities, thus hedging a portion of the overall position. To manage a portion of its exposure to currency remeasurement gains and losses in Brazil during fiscal year 2014, the Company entered into forward contracts to sell the Brazilian currency and buy U.S. dollars at future dates coinciding with expected changes in the overall net local currency monetary asset position of the subsidiary. Gains and losses on the forward contracts were recorded in earnings as a component of selling, general, and administrative expenses as they occurred, and thus directly offset the related remeasurement losses or gains in the consolidated statements of income for the notional amount hedged. Accordingly, the Company did not designate these contracts as hedges for accounting purposes. The notional amount of the contracts totaled approximately $50 million in U.S. dollars (based on the exchange rate at September 30, 2013). No forward contracts were entered for this purpose in fiscal year 2013.

Several of the Company’s foreign subsidiaries transact the majority of their sales and finance the majority of their operating requirements in their local currency, and therefore use their respective local currencies as the functional currency for reporting purposes. From time to time, these subsidiaries sell tobacco to customers in transactions that are not denominated in the functional currency. In those situations, the subsidiaries routinely enter into forward exchange contracts to offset currency risk for the period of time that a fixed-price order and the related trade account receivable are outstanding with the customer. The contracts are not designated as hedges for accounting purposes.

Effect of Derivative Financial Instruments on the Consolidated Statements of Income

The table below outlines the effects of the Company's use of derivative financial instruments on the consolidated statements of income for the three- and six-month periods ended September 30, 2013 and 2012:

	Three Months Ended September 30,		Six Months Ended September 30,	
(in thousands of dollars)	2013	2012	2013	2012
Cash Flow Hedges - Interest Rate Swap Agreements				
Derivative				
Effective Portion of Hedge				
Gain (loss) recorded in accumulated other comprehensive loss	$(482)	$(564)	$(172)	$(1,453)
Gain (loss) reclassified from accumulated other comprehensive loss into earnings	$(454)	$(226)	$(681)	$(455)
Location of gain (loss) reclassified from accumulated other comprehensive loss into earnings	Interest expense			
Ineffective Portion of Hedge				
Gain (loss) recognized in earnings	$—	$—	$—	$—
Location of gain (loss) recognized in earnings	Selling, general and administrative expenses			
Hedged Item				
Description of hedged item	Floating rate interest payments on term loan			
Cash Flow Hedges - Forward Foreign Currency Exchange Contracts				
Derivative				
Effective Portion of Hedge				
Gain (loss) recorded in accumulated other comprehensive loss	$(20)	$29	$(3,352)	$(7,900)
Gain (loss) reclassified from accumulated other comprehensive loss into earnings	$(2,362)	$(5,157)	$(2,437)	$(5,744)
Location of gain (loss) reclassified from accumulated other comprehensive loss into earnings	Cost of goods sold			
Ineffective Portion and Early De-designation of Hedges				
Gain (loss) recognized in earnings	$(71)	$92	$(1,839)	$(1,325)
Location of gain (loss) recognized in earnings	Selling, general and administrative expenses			
Hedged Item				
Description of hedged item	Forecast purchases of tobacco in Brazil			
Derivatives Not Designated as Hedges - Forward Foreign Currency Exchange Contracts				
Gain (loss) recognized in earnings	$(4,282)	$310	$(5,705)	$(1,959)
Location of gain (loss) recognized in earnings	Selling, general and administrative expenses			

For the forward foreign currency exchange contracts designated as cash flow hedges of tobacco purchases in Brazil, a net hedge loss of approximately $1.7 million remained in accumulated other comprehensive loss at September 30, 2013. That balance reflects net losses on settled contracts related to the 2013 crop, less the amount reclassified to earnings related to tobacco sold through September 30, 2013. The majority of the balance in the accumulated other comprehensive loss will be recognized in earnings as a component of cost of goods sold in fiscal year 2014, as the remaining 2013 Brazilian crop tobacco is sold to customers. Based on the hedging strategy, as the gain or loss is recognized in earnings, it is expected to be offset by a change in the direct cost for the tobacco or by a change in sales prices if the strategy has been mandated by the customer. Generally, margins on the sale of the tobacco will not be significantly affected.

Effect of Derivative Financial Instruments on the Consolidated Balance Sheets

The table below outlines the effects of the Company's derivative financial instruments on the consolidated balance sheets at September 30, 2013 and 2012, and March 31, 2013:

	Derivatives in a Fair Value Asset Position				Derivatives in a Fair Value Liability Position			
	Balance	Fair Value as of			Balance	Fair Value as of		
(in thousands of dollars)	Sheet Location	Sept. 30, 2013	Sept. 30, 2012	March 31, 2013	Sheet Location	Sept. 30, 2013	Sept. 30, 2012	March 31, 2013
Derivatives Designated as Hedging Instruments								
Interest rate swap agreements designated as cash flow hedges	Other non-current assets	$—	$—	$—	Other long-term liabilities	$1,170	$2,117	$1,679
Forward foreign currency exchange contracts	Other current assets	—	—	—	Accounts payable and accrued expenses	—	—	810
Total		$—	$—	$—		$1,170	$2,117	$2,489
Derivatives Not Designated as Hedging Instruments								
Forward foreign currency exchange contracts	Other current assets	$8	$230	$—	Accounts payable and accrued expenses	$4,511	$43	$331
Total		$8	$230	$—		$4,511	$43	$331

Substantially all of the Company's forward foreign exchange contracts are subject to master netting arrangements, whereby the right to offset occurs in the event of default by a participating party. The Company has elected to present these contracts on a gross basis in the consolidated balance sheets.

NOTE 8. FAIR VALUE MEASUREMENTS

Universal measures certain financial and nonfinancial assets and liabilities at fair value based on applicable accounting guidance. The financial assets and liabilities measured at fair value include money market funds, trading securities associated with deferred compensation plans, interest rate swap agreements, forward foreign currency exchange contracts, and guarantees of bank loans to tobacco growers. The application of the fair value guidance to nonfinancial assets and liabilities primarily includes assessments of goodwill and long-lived assets for potential impairment.

Under the accounting guidance, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The framework for measuring fair value is based on a fair value hierarchy that distinguishes between observable inputs (i.e., inputs that are based on market data obtained from independent sources) and unobservable inputs (i.e., inputs that require the Company to make its own assumptions about market participant assumptions because little or no market data exists). There are three levels within the fair value hierarchy:

Level	Description
1	quoted prices in active markets for identical assets or liabilities that the Company has the ability to access as of the reporting date;
2	quoted prices in active markets for similar assets or liabilities, or quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs other than quoted prices that are observable for the asset or liability; and
3	unobservable inputs for the asset or liability.

In measuring the fair value of liabilities, the Company considers the risk of non-performance in determining fair value.

At September 30, 2013 and 2012, and at March 31, 2013, the Company had certain financial assets and financial liabilities that were required to be measured and reported at fair value on a recurring basis. These assets and liabilities are listed in the tables below and are classified based on how their values were determined under the fair value hierarchy:

	September 30, 2013			
(in thousands of dollars)	Level 1	Level 2	Level 3	Total
Assets				
Money market funds	$—	$1,526	$—	$1,526
Trading securities associated with deferred compensation plans	19,174	—	—	19,174
Forward foreign currency exchange contracts	—	8	—	8
Total financial assets measured and reported at fair value	$19,174	$1,534	$—	$20,708
Liabilities				
Guarantees of bank loans to tobacco growers	$—	$—	$4,454	$4,454
Interest rate swap agreements				