CARDINAL HEALTH INC
Form 10-Q
May 08, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
Form 10-Q
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For The Quarter Ended March 31, 2006	**Commission File Number 1-11373**

Cardinal Health, Inc.
(Exact name of registrant as specified in its charter)

Ohio	**31-0958666**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

7000 CARDINAL PLACE, DUBLIN, OHIO 43017
(Address of principal executive offices and zip code)
(614) 757-5000
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No o

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

The number of Registrant s Common Shares outstanding at the close of business on April 30, 2006 was as follows:

Common Shares, without par value: 417,677,798

CARDINAL HEALTH, INC. AND SUBSIDIARIES

Index *

* Items not listed are inapplicable.

Table of Contents

PART I. FINANCIAL INFORMATION
Item 1: Financial Statements
CARDINAL HEALTH, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS
(Unaudited)
(in millions, except per Common Share amounts)

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2006	**2005**	**2006**	**2005**
Revenue	$ 20,637.5	$ 18,959.6	$ 59,655.3	$ 54,971.2
Cost of products sold	19,268.3	17,630.7	55,801.8	51,393.6
Gross margin	1,369.2	1,328.9	3,853.5	3,577.6
Selling, general and administrative expenses	778.6	678.7	2,345.4	2,026.5
Impairment charges and other	8.2	16.2	15.8	98.9
Special items restructuring charges	20.6	25.7	39.3	135.3
merger charges	7.5	9.9	20.8	36.3
other	(5.1)	7.1	(0.2)	2.4
Operating earnings	559.4	591.3	1,432.4	1,278.2
Interest expense and other	34.4	40.0	98.4	92.4
Earnings before income taxes and discontinued operations	525.0	551.3	1,334.0	1,185.8
Provision for income taxes	169.2	176.8	428.1	380.1
Earnings from continuing operations	355.8	374.5	905.9	805.7
Loss from discontinued operations (net of tax benefit/(expense) of $37.7 and $2.3, respectively, for the three months ended March 31, 2006 and 2005 and $44.1 and $(0.8), respectively, for the nine months ended March 31, 2006 and 2005)	(209.0)	(8.8)	(226.8)	(12.7)
Net earnings	$ 146.8	$ 365.7	$ 679.1	$ 793.0
Basic earnings per Common Share:				

Continuing operations	$	0.85	$	0.87	$	2.14	$	1.87
Discontinued operations		(0.50)		(0.02)		(0.54)		(0.03)
Net basic earnings per Common Share	$	0.35	$	0.85	$	1.60	$	1.84
Diluted earnings per Common Share:								
Continuing operations	$	0.83	$	0.86	$	2.11	$	1.84
Discontinued operations		(0.49)		(0.02)		(0.53)		(0.02)
Net diluted earnings per Common Share	$	0.34	$	0.84	$	1.58	$	1.82
Weighted average number of Common Shares outstanding:								
Basic		419.1		431.8		423.6		431.7
Diluted		427.5		437.8		430.1		436.7
Cash dividends declared per Common Share	$	0.06	$	0.03	$	0.18	$	0.09

See notes to condensed consolidated financial statements.

Table of Contents

CARDINAL HEALTH, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(in millions)

	(Unaudited) March 31, 2006	June 30, 2005
ASSETS		
Current assets:		
Cash and equivalents	$ 1,713.4	$ 1,400.0
Short-term investments available for sale	499.2	99.8
Trade receivables, net	3,937.5	3,102.3
Current portion of net investment in sales-type leases	273.7	238.2
Inventories	7,651.2	7,249.2
Prepaid expenses and other	863.1	838.9
Assets held for sale and discontinued operations	316.0	808.1
Total current assets	15,254.1	13,736.5
Property and equipment, at cost	4,807.4	4,582.5
Accumulated depreciation and amortization	(2,318.3)	(2,137.4)
Property and equipment, net	2,489.1	2,445.1
Other assets:		
Net investment in sales-type leases, less current portion	740.0	693.8
Goodwill and other intangibles, net	4,822.1	4,842.5
Other	340.3	341.3
Total assets	$ 23,645.6	$ 22,059.2
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term obligations and other short-term borrowings	$ 280.7	$ 307.9
Accounts payable	8,826.4	7,351.5
Other accrued liabilities	2,209.5	2,101.8
Liabilities from businesses held for sale and discontinued operations	155.2	345.5
Total current liabilities	11,471.8	10,106.7
Long-term obligations, less current portion and other short-term borrowings	2,548.2	2,319.9
Deferred income taxes and other liabilities	1,038.8	1,039.6

Shareholders equity:		
Preferred Shares, without par value Authorized 0.5 million shares, Issued none		
Common Shares, without par value Authorized 755.0 million shares, Issued 481.7 million shares and 476.5 million shares, respectively, at March 31, 2006 and June 30, 2005	3,113.8	2,765.5
Retained earnings	9,477.4	8,874.2
Common Shares in treasury, at cost, 64.1 million shares and 50.3 million shares, respectively, at March 31, 2006 and June 30, 2005	(3,998.3)	(3,043.6)
Other comprehensive (loss)/income	(6.1)	20.2
Other		(23.3)
Total shareholders equity	8,586.8	8,593.0
Total liabilities and shareholders equity	$ 23,645.6	$ 22,059.2

See notes to condensed consolidated financial statements.

CARDINAL HEALTH, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(in millions)

	Nine Months Ended March 31, 2006	Nine Months Ended March 31, 2005 Revised See Note 1
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net earnings	$ 679.1	$ 793.0
Loss from discontinued operations	226.8	12.7
Earnings from continuing operations	905.9	805.7
Adjustments to reconcile earnings from continuing operations to net cash provided by operating activities:		
Depreciation and amortization	291.1	287.0
Asset impairments	22.2	170.6
Equity compensation	185.2	7.2
Provision for bad debts	16.2	8.6
Change in operating assets and liabilities, net of effects from acquisitions:		
(Increase)/decrease in trade receivables	(848.0)	124.3
Increase in inventories	(401.9)	(344.7)
Increase in net investment in sales-type leases	(82.1)	(108.1)
Increase in accounts payable	1,470.0	1,122.4
Other accrued liabilities and operating items, net	98.5	(52.9)
Net cash provided by operating activities continuing operations	1,657.1	2,020.1
Net cash (used in)/provided by operating activities discontinued operations	(0.4)	10.8
Net cash provided by operating activities	1,656.7	2,030.9
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of subsidiaries, net of divestitures and cash acquired	(105.6)	(273.2)
Proceeds from sale of property and equipment	11.2	18.7
Additions to property and equipment	(330.5)	(276.7)
Purchase of investment securities available for sale	(399.4)	
Net cash used in investing activities continuing operations	(824.3)	(531.2)
Net cash (used in)/provided by investing activities discontinued operations	(1.1)	27.3
Net cash used in investing activities	(825.4)	(503.9)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in commercial paper and short-term borrowings	4.3	(551.0)
Reduction of long-term obligations	(260.7)	(1,617.0)

Proceeds from long-term obligations, net of issuance costs	510.9	1,261.2
Proceeds from issuance of Common Shares	227.5	87.2
Tax benefits from exercises of stock options	42.3	
Dividends on Common Shares	(76.6)	(38.9)
Purchase of treasury shares	(973.0)	(228.5)
Net cash used in financing activities continuing operations	(525.3)	(1,087.0)
Net cash provided by/(used in) financing activities discontinued operations	7.4	(7.1)
Net cash used in financing activities	(517.9)	(1,094.1)
NET INCREASE IN CASH AND EQUIVALENTS	313.4	432.9
CASH AND EQUIVALENTS AT BEGINNING OF PERIOD	1,400.0	1,102.2
CASH AND EQUIVALENTS AT END OF PERIOD	$ 1,713.4	$ 1,535.1

See notes to condensed consolidated financial statements.

Table of Contents

CARDINAL HEALTH, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation. The condensed consolidated financial statements of Cardinal Health, Inc. include the accounts of all majority-owned subsidiaries, and all significant inter-company amounts have been eliminated. (References to the Company in these condensed consolidated financial statements shall be deemed to be references to Cardinal Health, Inc. and its majority-owned subsidiaries unless the context otherwise requires.)

Effective the third quarter of fiscal 2006, the Company has revised its condensed consolidated statement of cash flows for the nine months ended March 31, 2005 to separately disclose the operating portions of the cash flows attributable to the Company s discontinued operations. The Company had previously reported these amounts within other accrued liabilities and operating items, net within its statement of cash flows.

Effective the third quarter of fiscal 2006, the Company reclassified a significant portion of its Healthcare Marketing Services business and its United Kingdom based Intercare Pharmaceutical Distribution business to discontinued operations. In addition, effective the first quarter of fiscal 2006, the Company reclassified its Sterile Pharmaceutical Manufacturing business in Humacao, Puerto Rico to discontinued operations. Prior period financial results were reclassified to conform to these changes in presentation. See Note 12 for additional information.

Also during the third quarter of fiscal 2006, the Company committed to a plan to sell a significant portion of the Specialty Distribution business. In accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the net assets held for sale of this business are presented separately on the condensed consolidated balance sheets and were recorded at the net expected fair value less costs to sell, as this amount was lower than the business net carrying value. See Note 12 for additional information.

These condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and include all of the information and disclosures required by United States generally accepted accounting principles (GAAP) for interim reporting. In the opinion of management, all adjustments necessary for a fair presentation have been included. Except as disclosed elsewhere in this Form 10-Q, all such adjustments are of a normal and recurring nature.

The condensed consolidated financial statements included in this Form 10-Q should be read in conjunction with the audited consolidated financial statements and related notes contained in Exhibit 99.1 to the Company s Current Report on Form 8-K dated December 6, 2005 (the December 6, 2005 Form 8-K). Without limiting the generality of the foregoing, Note 3 of the Notes to Consolidated Financial Statements from the December 6, 2005 Form 8-K is specifically incorporated into this Form 10-Q by reference.

Recent Financial Accounting Standards. In November 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 151, Inventory Costs-an amendment of ARB No. 43, Chapter 4. This Statement requires abnormal amounts of idle capacity and spoilage costs to be excluded from the cost of inventory and expensed when incurred. SFAS No. 151 is applicable to inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of this Statement did not have a material impact on the Company s financial position or results of operations.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets-an amendment of Accounting Principles Board (APB) Opinion No. 29. This Statement requires exchanges of productive assets to be accounted for at fair value, rather than at carryover basis, unless: (a) neither the asset received nor the asset surrendered has a fair value that is determinable within reasonable limits; or (b) the transactions lack commercial substance. This Statement is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of this Statement did not have a material impact on the Company s financial position or results of operations.

Table of Contents

In December 2004, the FASB issued SFAS No. 123(R), Share-Based Payment, which revises SFAS No. 123, Accounting for Stock-Based Compensation. SFAS No. 123(R) supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, and amends SFAS No. 95, Statement of Cash Flows. This Statement requires that a public entity measure the cost of equity-based service awards based on the grant date fair value of the award. All share-based payments to employees, including grants of employee stock options, are required to be recognized in the income statement based on their fair value. The Company adopted this Statement on July 1, 2005 (see Note 3 for the Company s disclosure).

In March 2005, the FASB issued FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations. This Interpretation clarifies the term of conditional asset retirement obligations as used in SFAS No. 143, Accounting for Asset Retirement Obligations. This Interpretation is effective no later than the end of fiscal years ending after December 15, 2005. The Company is in the process of determining the impact of adopting this Interpretation.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections. SFAS No. 154 is a replacement of APB Opinion No. 20, Accounting Changes and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements. This Statement requires voluntary changes in accounting to be accounted for retrospectively and all prior periods to be restated as if the newly adopted policy had always been used, unless it is impracticable. APB Opinion No. 20 previously required most voluntary changes in accounting to be recognized by including the cumulative effect of the change in accounting in net income in the period of change. This Statement also requires that a change in method of depreciation, amortization or depletion for a long-lived asset be accounted for as a change in estimate that is affected by a change in accounting principle. This Statement is effective for fiscal years beginning after December 15, 2005. Once adopted by the Company, this Statement could have an impact on prior year consolidated financial statements if the Company has a change in accounting.

In November 2005, the FASB issued FASB Staff Position (FSP) No. SFAS 115-1 and SFAS 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. This FSP amends SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, and SFAS No. 124, Accounting for Certain Investments Held by Not-for-Profit Organizations, and APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock. This FSP provides guidance on the determination of when an investment is considered impaired, whether that impairment is other-than-temporary and the measurement of an impairment loss. This FSP also requires disclosure about unrealized losses that have not been recognized as other-than-temporary impairments. This FSP is effective for reporting periods beginning after December 15, 2005. The adoption of this FSP did not have a material impact on the Company s financial position or results of operations.

In November 2005, the FASB issued FSP No. FAS 123(R)-3, Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards. This FSP provides that companies may elect to use a specified short-cut method to calculate the historical pool of windfall tax benefits upon adoption of SFAS No. 123(R). The option to use the short-cut method is available regardless of whether SFAS No. 123(R) was adopted using the modified prospective or modified retrospective application transition method, and whether it has the ability to calculate its pool of windfall tax benefits in accordance with the guidance in paragraph 81 of SFAS No. 123(R). This method only applies to awards that are fully vested and outstanding upon adoption of SFAS No. 123(R). This FSP became effective after November 10, 2005. The Company has elected the specified short cut method to calculate its beginning pool of additional paid-in capital related to equity-based compensation, and this election had no impact on the Company s financial statements (see Note 3 for the Company s disclosure).

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. This Statement permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that would otherwise be required to be bifurcated from its host contract. The election to measure a hybrid financial instrument at fair value, in its entirety, is irrevocable and all changes in fair value are to be recognized in earnings. This Statement also clarifies and amends certain provisions of SFAS No. 133 and SFAS No. 140. This Statement is effective for all financial instruments acquired, issued or subject to a remeasurement event occurring in fiscal years beginning after

September 15, 2006. Early adoption is permitted, provided the Company has not yet issued financial statements, including financial statements for any interim period, for that fiscal year. The adoption of this Statement is not expected to have a material impact on the Company s financial position or results of operations.

2. EARNINGS PER SHARE AND SHAREHOLDERS EQUITY

Basic earnings per Common Share (Basic EPS) is computed by dividing net earnings (the numerator) by the weighted average number of Common Shares outstanding during each period (the denominator). Diluted earnings per Common Share (Diluted EPS) is similar to the computation for Basic EPS, except that the denominator is increased by the dilutive effect of options outstanding and unvested restricted shares and share units, computed using the treasury stock method.

The following table reconciles the number of Common Shares used to compute Basic EPS and Diluted EPS for the three and nine months ended March 31, 2006 and 2005:

	For the Three Months Ended March 31,		For the Nine Months Ended March 31,	
(in millions)	2006	2005	2006	2005
Weighted-average Common Shares basic	419.1	431.8	423.6	431.7
Effect of dilutive securities:				
Employee options and unvested restricted shares and share units	8.4	6.0	6.5	5.0
Weighted-average Common Shares diluted	427.5	437.8	430.1	436.7

The potentially dilutive employee options that were antidilutive for the three months ended March 31, 2006 and 2005 were 5.0 million and 27.9 million, respectively, and for the nine months ended March 31, 2006 and 2005 were 26.1 million and 28.3 million, respectively.

3. EQUITY-BASED COMPENSATION

The Company maintains several stock incentive plans (collectively, the Plans) for the benefit of certain of its officers, directors and employees. Historically, employee options granted under the Plans generally vested in full on the third anniversary of the grant date and were exercisable for periods up to ten years from the date of grant at a price equal to the fair market value of the Common Shares underlying the option at the date of grant. Employee options granted under the Plans during the nine months ended March 31, 2006 generally vest in equal annual installments over four years and are exercisable for periods up to seven years from the date of grant at a price equal to the fair market value of the Common Shares underlying the option at the date of grant.

During the first quarter of fiscal 2006, the Company adopted SFAS No. 123(R), Share-Based Payment, applying the modified prospective method. This Statement requires all equity-based payments to employees, including grants of employee options, to be recognized in the condensed consolidated statement of earnings based on the grant date fair value of the award. Under the modified prospective method, the Company is required to record equity-based compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards outstanding as of the date of adoption. The fair values of options granted after the Company adopted this Statement were determined using a lattice valuation model and all options granted prior to adoption of this Statement were valued using a Black-Scholes model.

In anticipation of the adoption of SFAS No. 123(R), the Company did not modify the terms of any previously granted options. The Company made significant changes to its equity compensation program with its annual equity grant in the first quarter of fiscal 2006, including reducing the overall number of employee options granted and utilizing a mix of restricted share and option awards. The Company also moved generally from three-year cliff vesting to installment vesting over four years for employee option awards and shortened the option term from ten to seven years.

The fair value of restricted shares and restricted share units is determined by the number of shares granted and the grant date market price of the Company s Common Shares. The compensation expense recognized for all equity-based awards is net of estimated forfeitures and is recognized over the awards service period. In accordance with Staff

Accounting Bulletin (SAB   ) No. 107, the Company classified equity-based compensation within selling, general and administrative expenses to correspond with the same line item as the majority of the cash compensation paid to employees. The Company does not allocate the equity-based compensation to its reportable segments.

Table of Contents

In accordance with FSP No. FAS 123(R)-3 issued in November 2005, the Company elected the specified short cut method to calculate its beginning pool of additional paid-in capital related to equity-based compensation. This accounting policy election had no impact on the Company s financial statements.

The following table illustrates the impact of equity-based compensation on reported amounts:

(in millions, except per share amounts)	For Three Months Ended March 31, 2006 (1) As Reported	For Three Months Ended March 31, 2006 (1) Impact of Equity-Based Compensation	For the Nine Months Ended March 31, 2006 (1) As Reported	For the Nine Months Ended March 31, 2006 (1) Impact of Equity-Based Compensation
Operating earnings (2) (3) (4) (5)	$559.4	$ (48.7)	$1,432.4	$(185.2)
Earnings from continuing operations	$355.8	$ (32.7)	$ 905.9	$(119.5)
Net earnings	$146.8	$ (32.7)	$ 679.1	$(119.5)
Net basic earnings per Common Share	$ 0.35	$ (0.08)	$ 1.60	$ (0.28)
Net diluted earnings per Common Share	$ 0.34	$ (0.08)	$ 1.58	$ (0.28)

(1) Prior to the first quarter of fiscal 2006, the Company accounted for equity-based awards under the intrinsic value method, which followed the recognition and measurement principles of APB Opinion No. 25 and related Interpretations.

(2) The total equity-based compensation expense includes gross employee option expense of approximately $33.0 million and $115.8 million,

respectively, during the three and nine months ended March 31, 2006. The expense related to options represents the unvested portion of previously granted option awards outstanding as of the date of adoption and expense for all awards granted after the date of adoption.

(3) The total equity-based compensation expense includes gross stock appreciation rights (SARs) expense of approximately $5.9 million and $43.7 million, respectively, during the three and nine months ended March 31, 2006. This expense primarily relates to the previously reported August 3, 2005 SAR grant to the Company s then Chairman and Chief Executive Officer, Robert D. Walter, that

satisfied the Company s original intent and understanding with respect to a 1999 option award that was in excess of the number of shares permitted to be granted to a single individual during any fiscal year under the relevant equity compensation plan. Equity-based compensation expense was significantly impacted during the first quarter of fiscal 2006 from the vesting of the SARs upon issuance with an exercise price significantly below the then-current price of the Company s Common Shares. In subsequent quarters, the fair value of the SARs will be remeasured until they are settled, and any increase in fair value will be recorded as equity-based compensation. Any decrease in the fair value of the SARs will only be recognized to the extent of the expense previously recorded.

(4) The total equity-based compensation expense includes gross restricted share and restricted share unit expense of approximately $6.0 million and $16.8 million, respectively, during the three and nine months ended March 31, 2006.

(5) The total equity-based compensation expense also includes gross employee stock purchase plan expense of approximately $3.8 million and $8.9 million, respectively, during the three and nine months ended March 31, 2006.

Table of Contents

The following summarizes all option transactions for the Company under the Plans from July 1, 2005 through March 31, 2006:

	Options Outstanding (in millions)	Weighted Average Exercise Price per Common Share	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value (in millions)
Balance at June 30, 2005	47.6	$ 53.64		
Granted	4.8	$ 58.32		
Exercised	(4.4)	$ 44.23		
Canceled	(3.1)	$ 58.40		
Balance at March 31, 2006	44.9	$ 54.79	6.44	$ 495.0