ESTEE LAUDER COMPANIES INC
Form 10-Q
May 01, 2019
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)-

x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended March 31, 2019

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: 1-14064

The Estée Lauder Companies Inc.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**11-2408943** (I.R.S. Employer Identification No.)
767 Fifth Avenue, New York, New York (Address of principal executive offices)	**10153** (Zip Code)

212-572-4200

(Registrant s telephone number, including area code)

Not Applicable

(Former name or former address, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes x No o

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 o
Non-accelerated filer o	Smaller reporting company o
	Emerging growth company o

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. 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 x

At April 24, 2019, 219,271,734 shares of the registrant s Class A Common Stock, $.01 par value, and 142,600,834 shares of the registrant s Class B Common Stock, $.01 par value, were outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. ***Financial Statements.***

THE ESTÉE LAUDER COMPANIES INC.

CONSOLIDATED STATEMENTS OF EARNINGS

(Unaudited)

(In millions, except per share data)	Three Months Ended March 31 2019	Three Months Ended March 31 2018	Nine Months Ended March 31 2019	Nine Months Ended March 31 2018
Net sales	$ 3,744	$ 3,370	$ 11,273	$ 10,388
Cost of sales	819	683	2,552	2,147
Gross profit	2,925	2,687	8,721	8,241
Operating expenses				
Selling, general and administrative	2,170	2,092	6,435	6,266
Restructuring and other charges	29	97	99	198
Goodwill impairment	48		68	
Impairment of other intangible assets	4		22	
Total operating expenses	2,251	2,189	6,624	6,464
Operating income	674	498	2,097	1,777
Interest expense	32	33	101	96
Interest income and investment income, net	15	16	42	40
Other components of net periodic benefit cost	1	1	1	2
Other income, net	71		71	
Earnings before income taxes	727	480	2,108	1,719
Provision for income taxes	170	106	472	790
Net earnings	557	374	1,636	929
Net earnings attributable to noncontrolling interests	(2)	(2)	(8)	(7)
Net earnings attributable to The Estée Lauder Companies Inc.	$ 555	$ 372	$ 1,628	$ 922
Net earnings attributable to The Estée Lauder Companies Inc. per common share				
Basic	$ 1.53	$ 1.01	$ 4.47	$ 2.50
Diluted	$ 1.51	$ .99	$ 4.39	$ 2.45
Weighted-average common shares outstanding				
Basic	361.9	367.9	364.0	368.3

Diluted	368.3	375.7	370.9	375.7

See notes to consolidated financial statements.

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THE ESTÉE LAUDER COMPANIES INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Unaudited)

(In millions)	Three Months Ended March 31 2019	Three Months Ended March 31 2018	Nine Months Ended March 31 2019	Nine Months Ended March 31 2018
Net earnings	$ 557	$ 374	$ 1,636	$ 929
Other comprehensive income (loss):				
Net unrealized investment gain (loss)	9	(6)	14	(13)
Net derivative instrument gain (loss)	(7)	(14)	2	(19)
Amounts included in net periodic benefit cost	3	5	10	15
Translation adjustments	(72)	72	(87)	154
Provision for deferred income taxes on components of other comprehensive income	(1)	(4)	(4)	(6)
Total other comprehensive income (loss)	(68)	53	(65)	131
Comprehensive income	489	427	1,571	1,060
Comprehensive income attributable to noncontrolling interests:				
Net earnings	(2)	(2)	(8)	(7)
Translation adjustments			1	(1)
	(2)	(2)	(7)	(8)
Comprehensive income attributable to The Estée Lauder Companies Inc.	$ 487	$ 425	$ 1,564	$ 1,052

See notes to consolidated financial statements.

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THE ESTÉE LAUDER COMPANIES INC.

CONSOLIDATED BALANCE SHEETS

(In millions, except share data)		**March 31 2019 (Unaudited)**		**June 30 2018**
ASSETS				
Current assets				
Cash and cash equivalents	$	2,902	$	2,181
Short-term investments				534
Accounts receivable, net		2,036		1,487
Inventory and promotional merchandise, net		1,814		1,618
Prepaid expenses and other current assets		408		348
Total current assets		7,160		6,168
Property, plant and equipment, net		1,891		1,823
Other assets				
Long-term investments		173		843
Goodwill		1,865		1,926
Other intangible assets, net		1,215		1,276
Other assets		627		531
Total other assets		3,880		4,576
Total assets	$	12,931	$	12,567
LIABILITIES AND EQUITY				
Current liabilities				
Current debt	$	516	$	183
Accounts payable		1,068		1,182
Other accrued liabilities		2,647		1,945
Total current liabilities		4,231		3,310
Noncurrent liabilities				
Long-term debt		2,883		3,361
Other noncurrent liabilities		1,200		1,186
Total noncurrent liabilities		4,083		4,547
Contingencies				
Equity				
Common stock, $.01 par value; Class A shares authorized: 1,300,000,000 at March 31, 2019 and June 30, 2018; shares issued: 440,045,095 at March 31, 2019 and 435,413,976 at June 30, 2018; Class B shares authorized: 304,000,000 at March 31, 2019 and June 30, 2018; shares issued and outstanding: 142,600,834 at March 31, 2019 and 143,051,679 at June 30, 2018		6		6
Paid-in capital		4,331		3,972
Retained earnings		9,984		9,040
Accumulated other comprehensive loss		(498)		(434)
		13,823		12,584
Less: Treasury stock, at cost; 220,872,840 Class A shares at March 31, 2019 and 211,320,208 Class A shares at June 30, 2018		(9,235)		(7,896)
Total stockholders equity The Estée Lauder Companies Inc.		4,588		4,688
Noncontrolling interests		29		22

Total equity		4,617		4,710
Total liabilities and equity	$	12,931	$	12,567

See notes to consolidated financial statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In millions)	Nine Months Ended March 31 2019	2018
Cash flows from operating activities		
Net earnings	$ 1,636	$ 929
Adjustments to reconcile net earnings to net cash flows from operating activities:		
Depreciation and amortization	404	389
Deferred income taxes	(46)	84
Non-cash stock-based compensation	201	196
Net loss on disposal of property, plant and equipment	6	12
Non-cash restructuring and other charges		1
Pension and post-retirement benefit expense	53	54
Pension and post-retirement benefit contributions	(23)	(65)
Goodwill and other intangible assets impairments	90	
Changes in fair value of contingent consideration	(18)	(6)
Gain on liquidation of an investment in a foreign subsidiary, net	(71)	
Other non-cash items	(17)	(13)
Changes in operating assets and liabilities:		
Increase in accounts receivable, net	(377)	(325)
Increase in inventory and promotional merchandise, net	(184)	
Increase in other assets, net	(73)	(10)
Increase (decrease) in accounts payable	(105)	20
Increase in other accrued and noncurrent liabilities	280	654
Net cash flows provided by operating activities	1,756	1,920
Cash flows from investing activities		
Capital expenditures	(441)	(368)
Proceeds from the disposition of investments	1,229	716
Purchases of investments	(14)	(492)
Net cash flows provided by (used for) investing activities	774	(144)
Cash flows from financing activities		
Proceeds (repayments) of current debt, net	(167)	106
Repayments and redemptions of long-term debt	(1)	(1)
Net proceeds from stock-based compensation transactions	154	157
Payments to acquire treasury stock	(1,344)	(676)
Dividends paid to stockholders	(453)	(407)
Payments to noncontrolling interest holders for dividends	(3)	(1)
Net cash flows used for financing activities	(1,814)	(822)
Effect of exchange rate changes on Cash and cash equivalents	5	50
Net increase in Cash and cash equivalents	721	1,004
Cash and cash equivalents at beginning of period	2,181	1,136
Cash and cash equivalents at end of period	$ 2,902	$ 2,140

See notes to consolidated financial statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying consolidated financial statements include the accounts of The Estée Lauder Companies Inc. and its subsidiaries (collectively, the Company). All significant intercompany balances and transactions have been eliminated.

The unaudited interim consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (U.S. GAAP) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, all adjustments of a normal recurring nature considered necessary for a fair presentation have been included. The results of operations of any interim period are not necessarily indicative of the results of operations to be expected for the full fiscal year. The interim consolidated financial statements should be read in conjunction with the consolidated financial statements and accompanying footnotes included in the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2018.

Certain amounts in the consolidated financial statements of prior years have been reclassified to conform to current year presentation.

Management Estimates

The preparation of financial statements and related disclosures in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses reported in those financial statements. Descriptions of the Company s significant accounting policies are discussed in the notes to consolidated financial statements in the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2018. Management evaluates the related estimates and assumptions on an ongoing basis using historical experience and other factors, including the current economic environment, and makes adjustments when facts and circumstances dictate. As future events and their effects cannot be determined with precision, actual results could differ significantly from those estimates and assumptions. Significant changes, if any, in those estimates and assumptions resulting from continuing changes in the economic environment will be reflected in the consolidated financial statements in future periods.

Currency Translation and Transactions

All assets and liabilities of foreign subsidiaries and affiliates are translated at period-end rates of exchange, while revenue and expenses are translated at weighted-average rates of exchange for the period. Unrealized translation gains (losses), net of tax, reported as cumulative translation adjustments through other comprehensive income (loss) (OCI) attributable to The Estée Lauder Companies Inc. were $2 million and $65 million, net of tax, during the three months ended March 31, 2019 and 2018, respectively, and $(11) million and $149 million, net of tax, during the nine months ended March 31, 2019 and 2018, respectively. The Company had an investment in a foreign subsidiary that owned the Company s available-for-sale securities. During the three months ended March 31, 2019, the Company sold its available-for-sale securities, which liquidated this investment in the foreign subsidiary. As a result, the Company recorded a realized foreign currency gain on liquidation of $77 million and a gross loss on the sale of available-for-sale securities of $6 million, both of which were reclassified from accumulated OCI (AOCI) to Other income, net in the accompanying consolidated statement of earnings. See *Note 2 Investments* for additional information.

For the Company s subsidiaries operating in highly inflationary economies, the U.S. dollar is the functional currency. Remeasurement adjustments in financial statements in a highly inflationary economy and other transactional gains and losses are reflected in earnings. These subsidiaries are not material to the Company s consolidated financial statements or liquidity.

The Company enters into foreign currency forward contracts and may enter into option contracts to hedge foreign currency transactions for periods consistent with its identified exposures. Accordingly, the Company categorizes these instruments as entered into for purposes other than trading.

The accompanying consolidated statements of earnings include net exchange gains (losses) on foreign currency transactions of $73 million and $(26) million during the three months ended March 31, 2019 and 2018, respectively, and $52 million and $(61) million during the nine months ended March 31, 2019 and 2018, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Concentration of Credit Risk

The Company is a worldwide manufacturer, marketer and distributor of skin care, makeup, fragrance and hair care products. The Company s sales subject to credit risk are made primarily to department stores, perfumeries, specialty multi-brand retailers and retailers in its travel retail business. The Company grants credit to qualified customers and does not believe it is exposed significantly to any undue concentration of credit risk.

Inventory and Promotional Merchandise

Inventory and promotional merchandise, net consists of:

(In millions)	March 31 2019	June 30 2018
Raw materials	$ 501	$ 432
Work in process	218	222
Finished goods	931	798
Promotional merchandise	164	166
	$ 1,814	$ 1,618

Property, Plant and Equipment

(In millions)	March 31 2019	June 30 2018
Assets (Useful Life)		
Land	$ 29	$ 30
Buildings and improvements (10 to 40 years)	285	237
Machinery and equipment (3 to 10 years)	764	719
Computer hardware and software (4 to 10 years)	1,217	1,193
Furniture and fixtures (5 to 10 years)	122	104
Leasehold improvements	2,251	2,152
	4,668	4,435
Less accumulated depreciation and amortization	(2,777)	(2,612)
	$ 1,891	$ 1,823

The cost of assets related to projects in progress of $388 million and $300 million as of March 31, 2019 and June 30, 2018, respectively, is included in their respective asset categories above. Depreciation and amortization of property, plant and equipment was $121 million and $116 million during the three months ended March 31, 2019 and 2018, respectively, and $358 million and $342 million during the nine months ended March 31, 2019 and 2018, respectively. Depreciation and amortization related to the Company s manufacturing process is included in Cost of sales, and all other depreciation and amortization is included in Selling, general and administrative expenses in the accompanying consolidated statements of earnings.

Income Taxes

On December 22, 2017, the U.S. government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the TCJA). The TCJA includes broad and complex changes to the U.S. tax code that impacted the Company s accounting and reporting for income taxes. The impacts under the TCJA in the prior fiscal year primarily consisted of the following:

- A reduction in the U.S. federal corporate income tax rate from 35% to 21%, effective January 1, 2018, which resulted in a fiscal 2018 U.S. blended statutory income tax rate for the Company of 28.1%.
- A one-time mandatory deemed repatriation tax on unremitted foreign earnings (the Transition Tax), which the Company elected to pay over an eight-year period.
- A remeasurement of U.S. net deferred tax assets.
- The recognition of foreign withholding taxes in connection with the reversal of the Company s indefinite reinvestment assertion related to certain foreign earnings.

THE ESTÉE LAUDER COMPANIES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Staff Accounting Bulletin No. 118 (SAB 118) established a one-year measurement period (effective December 22, 2017), whereby provisional amounts recorded for effects of the changes from the TCJA could be subject to adjustment. The one-year measurement period expired on December 22, 2018 and, therefore, the accounting to record the effects of the changes from the TCJA was required to be completed during the three months ended December 31, 2018.

For the year ended June 30, 2018, the Company recorded the following provisional charges related to the TCJA:

- $351 million associated with the Transition Tax.
- $53 million in connection with the remeasurement of U.S. net deferred tax assets resulting from the statutory tax rate reduction.
- $46 million related to foreign withholding taxes associated with the reversal of its indefinite reinvestment assertion related to certain foreign earnings.

During the six months ended December 31, 2018, the Company recorded a credit of $12 million to adjust its fiscal 2018 provisional charge associated with the Transition Tax and reflected certain technical interpretations related to the Transition Tax computation. The final cumulative charge related to this matter is $339 million. The charges related to the Transition Tax are primarily included in Other noncurrent liabilities in the accompanying consolidated balance sheet as of March 31, 2019.

During the three months ended December 31, 2018, the Company recorded an increase of $8 million to its provisional charge recorded in fiscal 2018 associated with the remeasurement of its net deferred tax assets resulting from the reduction in the U.S. corporate income tax rate. This adjustment was due to the revision of certain temporary differences. The final cumulative charge related to this matter is $61 million.

In addition, the Company recorded a charge of $9 million for the three months ended September 30, 2018 related to foreign withholding taxes recorded in fiscal 2018 in connection with the reversal of its indefinite reinvestment assertion related to certain foreign earnings. This charge reflected the Company s interpretation of recently issued guidance from the U.S. government, and the accounting for this item pursuant to SAB 118 was considered complete as of September 30, 2018. The final cumulative charge related to this matter is $55 million.

Although the accounting related to the income tax effects of the TCJA is complete pursuant to SAB 118, certain technical aspects of the TCJA remain subject to varying degrees of uncertainty as additional technical guidance and clarification from the U.S. government is expected to be issued over an extended period. Receipt of additional guidance and clarification from the U.S. government may result in material changes to the provision for income taxes. To the extent applicable, the Company would recognize such adjustments in the provision for income taxes in the period that additional guidance and clarification is received.

Provisions under the TCJA that became effective for the Company in the current fiscal year include a further reduction in the U.S. statutory rate to 21%, a new minimum tax on global intangible low-taxed income (GILTI), a base erosion anti-abuse tax, a foreign derived intangible income deduction and changes to IRC Section 162(m) related to the deductibility of executive compensation.

For more information about the TCJA and the related impact on the Company, see *Note 8 Income Taxes* in the notes to consolidated financial statements in the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2018.

The effective rate for income taxes was 23.4% and 22.1% for the three months ended March 31, 2019 and 2018, respectively. This increase was primarily attributable to the goodwill impairment related to Smashbox, with no associated tax benefit, partially offset by a slightly lower effective tax rate on the Company s foreign operations due to a favorable geographic mix of earnings, partially offset by the impact of GILTI. See *Note 3 Goodwill and Other Intangible Assets* for additional information relating to the Smashbox impairments.

The effective rate for income taxes was 22.4% and 46.0% for the nine months ended March 31, 2019 and 2018, respectively. The decrease in the effective tax rate was primarily attributable to the provisional charges related to the TCJA that were recorded in the nine months ended March 31, 2018. Also contributing to the lower effective tax rate was the impact of the lower U.S. statutory tax rate and a lower effective tax rate on our foreign operations due to a favorable geographic mix of earnings, partially offset by the impact of GILTI and the goodwill impairment related to Smashbox.

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As of March 31, 2019 and June 30, 2018, the gross amount of unrecognized tax benefits, exclusive of interest and penalties, totaled $68 million and $60 million, respectively. The total amount of unrecognized tax benefits at March 31, 2019 that, if recognized, would affect the effective tax rate was $47 million. The total gross interest and penalties accrued related to unrecognized tax benefits during the three and nine months ended March 31, 2019 in the accompanying consolidated statements of earnings was $1 million and $4 million, respectively. The total gross accrued interest and penalties in the accompanying consolidated balance sheets at March 31, 2019 and June 30, 2018 was $13 million and $9 million, respectively. On the basis of the information available as of March 31, 2019, the Company does not expect significant changes to the total amount of unrecognized tax benefits within the next twelve months.

Other Accrued Liabilities

Other accrued liabilities consist of the following:

(In millions)	March 31 2019	June 30 2018
Advertising, merchandising and sampling	$ 413	$ 348
Employee compensation	500	579
Deferred revenue	299	33
Sales return accrual	209	
Payroll and other taxes	235	190
Accrued income taxes	228	90
Other	763	705
	$ 2,647	$ 1,945

Debt

In October 2018, the Company replaced its undrawn $1.5 billion senior unsecured revolving credit facility that was set to expire in October 2021 with a new $1.5 billion senior unsecured revolving credit facility (the New Facility). The New Facility expires on October 26, 2023 unless extended for up to two additional years in accordance with the terms set forth in the agreement. Up to the equivalent of $500 million of the New Facility is available for multi-currency loans. Interest rates on borrowings under the New Facility will be based on prevailing market interest rates in accordance with the agreement. The costs incurred to establish the New Facility were not material. The New Facility has an annual fee of approximately $1 million, payable quarterly, based on the Company s current credit ratings. The New Facility contains a cross-default provision whereby a failure to pay other material financial obligations in excess of $175 million (after grace periods and absent a waiver from the lenders) would result in an event of default and the acceleration of the maturity of any outstanding debt under this facility.

Recently Adopted Accounting Standards

Hedge Accounting

In August 2017, the Financial Accounting Standards Board (FASB) issued authoritative guidance to simplify hedge accounting. The guidance includes provisions that:

- enable entities to better portray their risk management activities within the financial statements;
- expand an entity s ability to hedge nonfinancial and financial risk components;
- reduce complexity in fair value hedges of interest rate risk;
- eliminate the requirement to separately measure and disclose hedge ineffectiveness;
- require the entire change in fair value of a hedging instrument to be presented in the same income statement line as the hedged item;
- ease certain documentation and assessment requirements;
- modify the accounting for components excluded from the assessment of hedge effectiveness; and
- require revised tabular footnote disclosure.

The guidance also provides transition relief to make it easier for entities to apply certain amendments to existing hedges (including fair value hedges) where the hedge documentation is required to be modified.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Effective for the Company Fiscal 2020 first quarter, with early adoption permitted in any interim period. The guidance must be applied:

- using the modified retrospective approach for cash flow and net investment hedge relationships that exist on the date of adoption; and
- prospectively for the presentation and disclosure requirements.

Impact on consolidated financial statements The Company has early adopted this guidance effective as of its fiscal 2019 first quarter, and no cumulative adjustment to retained earnings was required. Upon adoption, all derivative gains and losses will be recognized in the same income statement line as the hedged items which, for all foreign currency cash flow hedges, is in Net sales. There is no change to the interest expense classification of gains and losses from interest rate swap fair value hedges. The amended presentation and disclosure requirements are being applied prospectively. See *Note 5 Derivative Financial Instruments* for further information.

Pension-related Costs

In March 2017, the FASB issued authoritative guidance that amends how companies present net periodic benefit cost in the income statement and balance sheet relating to defined benefit pension and/or other postretirement benefit plans. Within the income statement, the new guidance requires companies to report the service cost component within operating expenses and report the other components of net periodic benefit cost below operating income. In addition, within the balance sheet, the guidance changes the components of the pension cost eligible for capitalization to the service cost component only (e.g., as a cost of internally manufactured inventory or a self-constructed asset).

Effective for the Company Fiscal 2019 first quarter. The guidance must be applied:

- retrospectively as it pertains to the income statement classification of the components of net periodic benefit cost; and
- prospectively as it pertains to future capitalization of service costs.

Impact on consolidated financial statements The Company adopted this guidance when it became effective, and although certain components of pension expense are being reclassified out of operating income, this did not have a material impact on reported operating income. The Company elected the practical expedient which permits the use of amounts previously disclosed in its pension and post-retirement plan footnote as the basis for estimating the amounts necessary to retrospectively restate the prior-year period consolidated statements of earnings.

Revenue from Contracts with Customers

In May 2014, the FASB issued authoritative guidance, Accounting Standards Codification Topic 606 Revenue from Contracts with Customers (ASC 606), that defines how companies should report revenues from contracts with customers. The standard requires an entity to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. It provides companies with a single comprehensive five-step principles-based model to use in accounting for revenue and supersedes prior revenue recognition requirements, including most industry-specific and transaction-specific revenue guidance.

In March 2016, the FASB issued authoritative guidance that amended the principal versus agent guidance in its new revenue recognition standard. These amendments do not change the key aspects of the principal versus agent guidance, including the definition that an entity is a principal if it controls the good or service prior to it being transferred to a customer, but the amendments clarify the implementation guidance related to the considerations that must be made during the contract evaluation process.

In April 2016, the FASB issued authoritative guidance that amended the new standard to clarify the guidance on identifying performance obligations and accounting for licenses of intellectual property.

In May 2016, the FASB issued authoritative guidance that clarified certain terms, guidance and disclosure requirements during the transition period related to completed contracts and contract modifications. In addition, the FASB provided clarification on the concept of collectability, the calculation of the fair value of noncash consideration and the presentation of sales and other similar taxes.

In May 2016, the FASB issued authoritative guidance to reflect the Securities and Exchange Commission Staff s rescission of its prior comments that covered, among other things, accounting for shipping and handling costs and accounting for consideration given by a vendor to a customer.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In December 2016, the FASB issued authoritative guidance that amends various aspects of the new standard to clarify certain terms, guidance and disclosure requirements. In particular, the guidance addresses disclosure requirements for remaining performance obligations, impairment testing for contract costs and accrual of advertising costs, as well as clarifies several examples.

Effective for the Company Fiscal 2019 first quarter. An entity is permitted to apply the foregoing guidance retrospectively to all prior periods presented, with certain practical expedients, or apply the requirements in the year of adoption, through a cumulative adjustment.

Impact on consolidated financial statements On July 1, 2018, the Company adopted ASC 606, see *Note 7 Revenue Recognition* for further discussion.

Goodwill

In January 2017, the FASB issued authoritative guidance that simplifies the subsequent measurement of goodwill by eliminating the second step from the quantitative goodwill impairment test. The single quantitative step test requires companies to compare the fair value of a reporting unit with its carrying amount and record an impairment charge for the amount that the carrying amount exceeds the fair value, up to the total amount of goodwill allocated to that reporting unit. The Company will continue to have the option of first performing a qualitative assessment to determine whether it is necessary to perform the quantitative goodwill impairment test.

Effective for the Company Fiscal 2021 first quarter, with early adoption permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017.

Impact on consolidated financial statements The Company early adopted this guidance effective as of its fiscal 2019 second quarter and applied the new guidance in its quantitative goodwill impairment test related to the Smashbox reporting unit. See *Note 3 Goodwill and Other Intangible Assets* for further information.

Recently Issued Accounting Standards

Measurement of Credit Losses on Financial Instruments

In June 2016, the FASB issued authoritative guidance that requires companies to utilize an impairment model for most financial assets measured at amortized cost and certain other financial instruments, which include trade and other receivables, loans and held-to-maturity debt securities, to record an allowance for credit risk based on expected losses rather than incurred losses. In addition, this guidance changes the recognition method for credit losses on available-for-sale debt securities, which can occur as a result of market and credit risk, and requires additional disclosures. In general, modified retrospective adoption will be required for all outstanding instruments that fall under this guidance.

Effective for the Company Fiscal 2021 first quarter.

Impact on consolidated financial statements The Company is currently evaluating the impact of applying this guidance on its financial instruments, such as accounts receivable and short- and long-term investments.

Leases

In February 2016, the FASB issued authoritative guidance that requires lessees to account for most leases on their balance sheets with the liability being equal to the present value of the lease payments. The right-of-use asset will be based on the lease liability adjusted for certain costs such as initial direct costs, prepaid lease payments and lease incentives received. Lease expense will be recognized similar to current accounting guidance with operating leases resulting in a straight-line expense, and finance leases resulting in a front-loaded expense similar to the current accounting for capital leases.

In July 2018, the FASB amended this guidance to clarify certain narrow aspects of the new lease accounting standard that may have been incorrectly or inconsistently applied, and does not add new guidance. Also in July 2018, the FASB issued authoritative guidance that allows companies to elect to adopt the new standard using a modified retrospective transition approach with a cumulative-effect adjustment to retained earnings in the period of adoption. Companies that elect the new adoption method will not be required to restate the prior comparative periods in the financial statements.

Effective for the Company Fiscal 2020 first quarter, with early adoption permitted using either of the modified retrospective transition approaches described in the standard, with certain practical expedients.

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Impact on consolidated financial statements The Company currently has an implementation team in place that is performing a comprehensive evaluation of the impact of the adoption of this guidance, which includes assessing the Company s lease portfolio, implementing a new system to meet reporting requirements, and assessing the impact to business processes and internal controls over financial reporting and the related disclosure requirements. While the Company s evaluation is ongoing, it believes the adoption of this standard will have a significant impact on its consolidated balance sheets, but will not have a material impact to its consolidated statements of earnings, earnings per share amounts and consolidated statements of cash flows**.** As disclosed in *Note 14 Commitments and Contingencies* in the notes to consolidated financial statements in the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2018, the Company had $3,320 million in future minimum lease commitments as of June 30, 2018. Upon adoption, the Company s lease liability will generally be based on the present value of such payments and the related right-of-use asset will generally be based on the lease liability, adjusted for initial direct costs, prepaid lease payments, lease incentives received and deferred rent. The Company plans to adopt the new standard when it becomes effective in the fiscal 2020 first quarter using the modified retrospective transition approach for leases that exist in the period of adoption and will not restate the prior comparative periods. Under this method, the Company is required to assess the remaining future payments and lease terms of existing leases as of the beginning of the fiscal 2020 first quarter, but is not required to assess leases that expire prior to fiscal 2020. Additionally, as of the date of adoption, the Company expects to elect the package of practical expedients that does not require the Company to 1) assess whether expired or existing contracts contain leases, 2) reassess the lease classification (i.e. operating lease vs. finance lease) for expired or existing leases and 3) change the accounting for initial direct costs.

Goodwill and Other Internal-Use Software

In August 2018, the FASB issued authoritative guidance that permits companies to capitalize the costs incurred for setting up business systems that operate on cloud technology. The new guidance aligns the requirement for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. The guidance does not affect the accounting for the service element of a hosting arrangement that is a service contract. Capitalized costs associated with a hosting arrangement that is a service contract must be amortized over the term of the hosting arrangement to the same line item in the income statement as the expense for fees for the hosting arrangement.

Effective for the Company Fiscal 2021 first quarter, with early adoption permitted in any interim period. This guidance can be adopted either:

- retrospectively; or
- prospectively to all implementation costs incurred after the date of adoption.

Impact on consolidated financial statements The Company is currently evaluating the impact of applying this guidance to its business systems that operate on cloud technology.

No other recently issued accounting pronouncements are expected to have a material impact on the Company s consolidated financial statements.

NOTE 2 INVESTMENTS

Beginning in the first quarter of fiscal 2019, the Company accounts for its cost method investments at cost, less impairment, plus/minus subsequent observable price changes, and will be required to perform an assessment each quarter to determine whether or not a triggering event has occurred that results in changes in fair value. These investments were not material to the Company s consolidated financial statements as of March 31, 2019.

During the three months ended March 31, 2019, the Company sold its available-for-sale securities, which liquidated its investment in the foreign subsidiary that owned those securities, and realized a gross loss of $6 million and a foreign currency gain of $77 million, both of which are reflected in Other income, net in the accompanying consolidated statement of earnings.

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Gains and losses recorded in AOCI related to the Company s available-for-sale investments as of June 30, 2018 were as follows:

(In millions)	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government and agency securities	$ 427	$	$ (5)	$ 422
Foreign government and agency securities	114		(2)	112
Corporate notes and bonds	479		(7)	472
Time deposits	200			200
Other securities	16			16
Total	$ 1,236	$	$ (14)	$ 1,222

The Company utilizes the first-in, first-out method to determine the cost of the security sold. Sales proceeds from investments classified as available-for-sale were $910 million and $21 million for the three months ended March 31, 2019 and 2018, respectively, and were $933 million and $317 million for the nine months ended March 31, 2019 and 2018, respectively.

NOTE 3 GOODWILL AND OTHER INTANGIBLE ASSETS

Impairment Testing During the Nine Months Ended March 31, 2019

During December 2018, the Smashbox reporting unit made revisions to its internal forecasts reflecting a slowdown of its makeup business driven by increased competitive activity and lower than expected growth in key retail channels for the brand. The Company concluded that these changes in circumstances in the Smashbox reporting unit triggered the need for an interim impairment review of its trademark and goodwill. Accordingly, the Company performed an interim impairment test as of December 31, 2018. The Company concluded that the carrying value of the Smashbox trademark exceeded its estimated fair value, which was determined utilizing a royalty rate to determine discounted projected future cash flows. As a result, the Company recognized an impairment charge of $18 million for the trademark during the three months ended December 31, 2018. After adjusting the carrying value of the trademark, the Company completed an interim quantitative impairment test for goodwill and recorded a goodwill impairment charge related to the Smashbox reporting unit of $20 million during the three months ended December 31, 2018.

During March 2019, the Smashbox reporting unit made additional revisions to its internal forecasts reflecting the continued slowdown of its makeup business driven by ongoing competitive activity and lower than expected growth in key retail channels for the brand. The Company concluded that these changes in circumstances in the Smashbox reporting unit triggered the need for an interim impairment review of its trademark and goodwill. Accordingly, the Company performed an interim impairment test as of March 31, 2019. The Company concluded that the carrying value of the Smashbox trademark exceeded its estimated fair value, which was determined utilizing a royalty rate to determine discounted projected future cash flows. As a result, the Company recognized an impairment charge of $4 million for the trademark during the three months ended March 31, 2019. After adjusting the carrying value of the trademark, the Company completed an interim quantitative impairment test for goodwill and recorded a goodwill impairment charge related to the Smashbox reporting unit of $48 million during the three months ended March 31, 2019. The cumulative impairment charges for the trademark and goodwill during the nine months ended March 31, 2019 were $22 million and $68 million, respectively.

In the second quarter of fiscal 2019, the Company early adopted the FASB s authoritative guidance that eliminated the second step from the quantitative goodwill impairment test. In accordance with this guidance, the Company compared the fair value of the Smashbox reporting unit with its carrying amount to calculate the impairment charge. The fair values of the reporting unit as of December 31, 2018 and March 31, 2019 were based upon an equal weighting of the income and market approaches, utilizing estimated cash flows and a terminal value, discounted at a rate of return that reflects the relative risk of the cash flows, as well as valuation multiples derived from comparable publicly traded companies that are applied to operating performance of the reporting unit. These impairment charges were reflected in the makeup product category and in the Americas region. As of March 31, 2019, the remaining carrying values of the goodwill and trademark related to the Smashbox reporting unit were $72 million and $55 million, respectively.

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The following table presents goodwill by product category and the related change in the carrying amount:

(In millions)	Skin Care	Makeup	Fragrance	Hair Care	Total
Balance as of June 30, 2018					
Goodwill	$ 185	$ 1,186	$ 256	$ 391	$ 2,018
Accumulated impairments	(36)		(22)	(34)	(92)
	149	1,186	234	357	1,926
Goodwill acquired during the period		10			10
Impairment charges		(68)			(68)
Translation adjustments, goodwill	(1)		(2)	(1)	(4)
Translation adjustments, accumulated impairments	1				1
		(58)	(2)	(1)	(61)
Balance as of March 31, 2019					
Goodwill	184	1,196	254	390	2,024
Accumulated impairments	(35)	(68)	(22)	(34)	(159)
	$ 149	$ 1,128	$ 232	$ 356	$ 1,865

Other intangible assets consist of the following:

	March 31, 2019	June 30, 2018
(In millions)	Gross Carrying Value	