

MCDONALDS CORP
Form 10-Q
May 08, 2012

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 quarterly period ended March 31, 2012

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission File Number 1-5231

McDONALD S CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

36-2361282
(I.R.S. Employer
Identification No.)

One McDonald s Plaza
Oak Brook, Illinois
(Address of Principal Executive Offices)

60523
(Zip Code)

(630) 623-3000

(Registrant s Telephone Number, Including Area Code)

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

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer (do not check if a smaller reporting company)

Smaller reporting company

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

1,016,244,880

(Number of shares of common stock

outstanding as of March 31, 2012)

MCDONALD S CORPORATION

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

CONDENSED CONSOLIDATED BALANCE SHEET

In millions, except per share data	(unaudited) March, 31 2012	December 31, 2011
Assets		
Current assets		
Cash and equivalents	\$ 2,289.1	\$ 2,335.7
Accounts and notes receivable	1,234.4	1,334.7
Inventories, at cost, not in excess of market	111.7	116.8
Prepaid expenses and other current assets	619.6	615.8
Total current assets	4,254.8	4,403.0
Other assets		
Investments in and advances to affiliates	1,366.0	1,427.0
Goodwill	2,719.1	2,653.2
Miscellaneous	1,689.8	1,672.2
Total other assets	5,774.9	5,752.4
Property and equipment		
Property and equipment, at cost	36,623.6	35,737.6
Accumulated depreciation and amortization	(13,319.1)	(12,903.1)
Net property and equipment	23,304.5	22,834.5
Total assets	\$ 33,334.2	\$ 32,989.9
Liabilities and shareholders' equity		
Current liabilities		
Accounts payable	\$708.3	\$961.3
Income taxes	491.8	262.2
Other taxes	360.9	338.1
Accrued interest	156.4	218.2
Accrued payroll and other liabilities	1,204.8	1,362.8
Current maturities of long-term debt	724.2	366.6
Total current liabilities	3,646.4	3,509.2
Long-term debt	12,055.7	12,133.8
Other long-term liabilities	1,575.4	1,612.6
Deferred income taxes	1,396.2	1,344.1
Shareholders' equity		
Preferred stock, no par value; authorized 165.0 million shares; issued none		
Common stock, \$.01 par value; authorized 3.5 billion shares; issued 1,660.6 million shares	16.6	16.6
Additional paid-in capital	5,564.2	5,487.3
Retained earnings	37,262.5	36,707.5
Accumulated other comprehensive income	799.2	449.7
Common stock in treasury, at cost; 644.4 and 639.2 million shares	(28,982.0)	(28,270.9)
Total shareholders' equity	14,660.5	14,390.2
Total liabilities and shareholders' equity	\$ 33,334.2	\$ 32,989.9

See Notes to condensed consolidated financial statements.

CONDENSED CONSOLIDATED STATEMENT OF NET INCOME AND COMPREHENSIVE INCOME (UNAUDITED)

	Quarters Ended	
	March 31, 2012	2011
In millions, except per share data		
Revenues		
Sales by Company-operated restaurants	\$ 4,432.2	\$ 4,152.7
Revenues from franchised restaurants	2,114.4	1,958.9
Total revenues	6,546.6	6,111.6
Operating costs and expenses		
Company-operated restaurant expenses	3,654.4	3,416.7
Franchised restaurants occupancy expenses	374.7	354.3
Selling, general & administrative expenses	592.5	563.6
Other operating (income) expense, net	(39.6)	(48.9)
Total operating costs and expenses	4,582.0	4,285.7
Operating income	1,964.6	1,825.9
Interest expense	128.9	120.1
Nonoperating (income) expense, net	(11.8)	6.9
Income before provision for income taxes	1,847.5	1,698.9
Provision for income taxes	580.8	489.9
Net income	\$ 1,266.7	\$ 1,209.0
Earnings per common share-basic	\$ 1.24	\$ 1.16
Earnings per common share-diluted	\$ 1.23	\$ 1.15
Dividends declared per common share	\$ 0.70	\$ 0.61
Weighted average shares outstanding-basic	1,018.2	1,042.4
Weighted average shares outstanding-diluted	1,030.0	1,054.6
Comprehensive income	\$ 1,616.2	\$ 1,710.3

See Notes to condensed consolidated financial statements.

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

In millions	Quarters Ended	
	March 31,	
	2012	2011
Operating activities		
Net income	\$ 1,266.7	\$ 1,209.0
Adjustments to reconcile to cash provided by operations		
Charges and credits:		
Depreciation and amortization	364.7	339.1
Deferred income taxes	22.6	(13.0)
Share-based compensation	26.5	24.0
Other	(48.9)	(9.7)
Changes in working capital items	1.9	3.7
Cash provided by operations	1,633.5	1,553.1
Investing activities		
Capital expenditures	(588.4)	(508.7)
Sales and purchases of restaurant businesses and property sales	9.7	(8.8)
Other	(18.7)	(1.7)
Cash used for investing activities	(597.4)	(519.2)
Financing activities		
Short-term borrowings and long-term financing issuances and repayments	267.2	429.3
Treasury stock purchases	(812.6)	(1,370.6)
Common stock dividends	(712.3)	(635.1)
Proceeds from stock option exercises	84.4	61.7
Excess tax benefit on share-based compensation	46.7	21.8
Other	(4.8)	(19.4)
Cash used for financing activities	(1,131.4)	(1,512.3)
Effect of exchange rates on cash and cash equivalents	48.7	31.3
Cash and equivalents decrease	(46.6)	(447.1)
Cash and equivalents at beginning of period	2,335.7	2,387.0
Cash and equivalents at end of period	\$ 2,289.1	\$ 1,939.9

See Notes to condensed consolidated financial statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**Basis of Presentation**

The accompanying condensed consolidated financial statements should be read in conjunction with the consolidated financial statements contained in the Company's December 31, 2011 Annual Report on Form 10-K. In the opinion of management, all adjustments (consisting of normal recurring accruals) necessary for a fair presentation have been included. The results for the quarter ended March 31, 2012 do not necessarily indicate the results that may be expected for the full year.

Restaurant Information

The following table presents restaurant information by ownership type:

Restaurants at March 31,	2012	2011
Conventional franchised	19,487	19,306
Developmental licensed	3,965	3,529
Foreign affiliated	3,622	3,563
Total Franchised	27,074	26,398
Company-operated	6,443	6,407
Systemwide restaurants	33,517	32,805

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

Comprehensive Income

The following table presents the components of comprehensive income for the quarters ended March 31, 2012 and 2011:

In millions	Quarters Ended	
	March 31,	
	2012	2011
Net income	\$ 1,266.7	\$ 1,209.0
Other comprehensive income (loss):		
Foreign currency translation adjustments, net of hedging	352.5	483.7
Cash flow hedging adjustments	(3.5)	(3.5)
Pension liability adjustment	0.5	21.1
Total other comprehensive income (loss)	349.5	501.3
Total comprehensive income	\$ 1,616.2	\$ 1,710.3

In June 2011, the Financial Accounting Standards Board issued an update to Topic 220 Comprehensive Income of the Accounting Standards Codification (ASC). The update is intended to increase the prominence of other comprehensive income in the financial statements. The guidance requires that the Company presents components of comprehensive income in either one continuous statement or two separate consecutive statements and no longer permits the presentation of comprehensive income in the Consolidated statement of shareholders' equity. The Company adopted this new guidance effective January 1, 2012, as required, and included comprehensive income in the Condensed consolidated statement of net income and comprehensive income (unaudited) for interim reporting.

Per Common Share Information

Diluted earnings per common share is calculated using net income divided by diluted weighted-average shares. Diluted weighted-average shares include weighted-average shares outstanding plus the dilutive effect of share-based compensation, calculated using the treasury stock method, of 11.8 million shares and 12.2 million shares for the first quarter 2012 and 2011, respectively. Stock options that were not included in the

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calculation of diluted weighted-average shares because they would have been antidilutive were 4.7 million shares and 3.9 million shares for the first quarter 2012 and 2011, respectively.

Fair Value Measurements

The Company measures certain financial assets and liabilities at fair value on a recurring basis, and certain non-financial assets and liabilities on a nonrecurring basis. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market in an orderly transaction between market participants on the measurement date. Fair value disclosures are reflected in a three-level hierarchy, maximizing the use of observable inputs and minimizing the use of unobservable inputs.

The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability on the measurement date. The three levels are defined as follows:

Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for an identical asset or liability in an active market.

Level 2 inputs to the valuation methodology include quoted prices for a similar asset or liability in an active market or model-derived valuations in which all significant inputs are observable for substantially the full term of the asset or liability.

Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement of the asset or liability. Certain of the Company's derivatives are valued using various pricing models or discounted cash flow analyses that incorporate observable market parameters, such as interest rate yield curves, option volatilities and currency rates, classified as Level 2 within the valuation hierarchy. Derivative valuations incorporate credit risk adjustments that are necessary to reflect the probability of default by the counterparty or the Company.

Certain Financial Assets and Liabilities Measured at Fair Value

The following table presents financial assets and liabilities measured at fair value on a recurring basis by the valuation hierarchy as defined in the fair value guidance:

In millions	Level 1	Level 2	Level 3	Carrying Value
<i>March 31, 2012</i>				
Cash equivalents	\$ 429.0			\$ 429.0
Investments	144.6*			144.6
Derivative assets	151.7*	\$ 63.3		215.0
Total assets at fair value	\$ 725.3	\$ 63.3		\$ 788.6
Derivative liabilities		\$ (7.0)		\$ (7.0)
Total liabilities at fair value		\$ (7.0)		\$ (7.0)
<i>December 31, 2011</i>				
Cash equivalents	\$ 581.7			\$ 581.7
Investments	132.4*			132.4
Derivative assets	154.5*	\$ 71.1		225.6
Total assets at fair value	\$ 868.6	\$ 71.1		\$ 939.7
Derivative liabilities		\$ (15.6)		\$ (15.6)
Total liabilities at fair value		\$ (15.6)		\$ (15.6)

* Includes long-term investments and derivatives that hedge market-driven changes in liabilities associated with the Company's supplemental benefit plans.

Non-Financial Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

Certain assets and liabilities are measured at fair value on a nonrecurring basis; that is, the assets and liabilities are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (e.g., when there is evidence of impairment). At March 31, 2012, no material fair value adjustments or fair value measurements were required for non-financial assets or liabilities.

Certain Financial Assets and Liabilities not Measured at Fair Value

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At March 31, 2012, the fair value of the Company's debt obligations was estimated at \$14.4 billion, compared to a carrying amount of \$12.8 billion. The fair value was based on quoted market prices, Level 2 within the valuation hierarchy. The carrying amount for both cash and equivalents and notes receivable approximate fair value.

Financial Instruments and Hedging Activities

The Company is exposed to global market risks, including the effect of changes in interest rates and foreign currency fluctuations. The Company uses foreign currency denominated debt and derivative instruments to mitigate the impact of these changes. The Company does not use derivatives with a level of complexity or with a risk higher than the exposures to be hedged and does not hold or issue derivatives for trading purposes.

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The Company documents its risk management objective and strategy for undertaking hedging transactions, as well as all relationships between hedging instruments and hedged items. The Company's derivatives that are designated as hedging instruments consist mainly of interest rate swaps, foreign currency forwards and foreign currency options. Interest rate swaps are entered into to manage the interest rate risk associated with the Company's fixed and floating-rate borrowings. Foreign currency forwards and foreign currency options are entered into to mitigate the risk that forecasted foreign currency cash flows (such as royalties denominated in foreign currencies) will be adversely affected by changes in foreign currency exchange rates. Certain foreign currency denominated debt is used, in part, to protect the value of the Company's investments in certain foreign subsidiaries and affiliates from changes in foreign currency exchange rates.

The Company also enters into certain derivatives that are not designated as hedging instruments. The Company has entered into equity derivative contracts to hedge market-driven changes in certain of its supplemental benefit plan liabilities. Changes in the fair value of these derivatives are recorded in Selling, general & administrative expenses together with the changes in the supplemental benefit plan liabilities. In addition, the Company uses foreign currency forwards to mitigate the change in fair value of certain foreign currency denominated assets and liabilities. Since these derivatives are not designated for hedge accounting, the changes in the fair value of these derivatives are recognized immediately in nonoperating (income) expense together with the currency gain or loss from the hedged balance sheet position. A portion of the Company's foreign currency options (more fully described in the Cash Flow Hedging Strategy section) are undesignated as hedging instruments as the underlying foreign currency royalties are earned.

All derivative instruments designated as hedging instruments are classified as fair value, cash flow or net investment hedges. All derivatives (including those not designated for hedge accounting) are recognized on the Consolidated balance sheet at fair value and classified based on the instruments' maturity date. Changes in the fair value measurements of the derivative instruments are reflected as adjustments to other comprehensive income (OCI) and/or current earnings.

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

<i>In millions</i>	Derivative Assets			Derivative Liabilities		
	<i>Balance Sheet Classification</i>	March 31, 2012	December 31, 2011	<i>Balance Sheet Classification</i>	March 31, 2012	December 31, 2011
Derivatives designated as hedging instruments						
Foreign currency				Accrued payroll and other		
	Prepaid expenses and other current assets	\$ 5.3	\$ 6.7	liabilities	\$ (0.2)	\$ (0.3)
Interest rate	Prepaid expenses and other current assets	21.2	9.4			
	Miscellaneous other assets	1.1	0.7	Other long-term liabilities	(3.9)	(0.3)
Foreign currency	Miscellaneous other assets	30.1	46.0	Other long-term liabilities		(14.0)
Interest rate		\$ 57.7	\$ 62.8		\$ (4.1)	\$ (14.6)
Total derivatives designated as hedging instruments						
Derivatives not designated as hedging instruments						
Foreign currency	Prepaid expenses and other current assets	\$ 5.6	\$ 8.3	Accrued payroll and other liabilities	\$ (2.9)	\$ (1.0)
Equity	Miscellaneous other assets	151.7	154.5			
Total derivatives not designated as hedging instruments		\$ 157.3	\$ 162.8		\$ (2.9)	\$ (1.0)
Total derivatives		\$ 215.0	\$ 225.6		\$ (7.0)	\$ (15.6)

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The following table presents the pretax amounts affecting income and OCI for the three months ended March 31, 2012 and 2011, respectively:

In millions

Derivatives in	Gain (Loss)		Hedged Items in	Gain (Loss)	
	Recognized in Income on			Recognized in Income on	
Fair Value	Derivative		Fair Value	Related Hedged Items	
Hedging					
Relationships	2012	2011	Hedging Relationships	2012	2011
Interest rate	\$ (4.1)	\$ (21.5)	Fixed-rate debt	\$ 4.1	\$ 21.5
Derivatives in	Gain (Loss)		Gain (Loss)	Gain (Loss)	
	Recognized in Accumulated			Reclassified from	
Cash flow	OCI on Derivative		Accumulated OCI into		Derivative (Amount Excluded
Hedging	(Effective Portion)		Income (Effective Portion)		
Relationships	2012	2011	2012	2011	Ineffective
Foreign currency	\$ (5.2)	\$ (4.0)	\$ (4.7)	\$ 0.9	\$ (2.5)
Interest rate ⁽¹⁾	(4.6)		0.3	0.6	\$ (4.5)
Total	\$ (9.8)	\$ (4.0)	\$ (4.4)	\$ 1.5	\$ (4.5)
Net Investment	Gain (Loss)		Derivatives Not	Gain (Loss)	
	Recognized in Accumulated			Recognized in Income	
Hedging Relationships	OCI on Derivative		on Derivative		
	(Effective portion)		Hedging		
	2012	2011	Instruments	2012	2011
Foreign currency denominated debt	\$ (1.5)	\$ (112.5)	Foreign Currency	\$ (1.1)	\$ (2.0)
Foreign currency derivatives		(7.4)	Equity ⁽²⁾	(2.7)	(0.8)
Total	\$ (1.5)	\$ (119.9)	Total	\$ (3.8)	\$ (2.8)

Gains (losses) recognized in income on derivatives are recorded in Nonoperating (income) expense, net unless otherwise noted.

(1) The amount of gain (loss) reclassified from accumulated OCI into income is recorded in Interest expense.

(2) The amount of gain (loss) recognized in income on the derivatives used to hedge the supplemental benefit plan liabilities is recorded in Selling, general & administrative expenses.

Fair Value Hedges

The Company enters into fair value hedges to reduce the exposure to changes in the fair values of certain liabilities. The fair value hedges the Company enters into consist of interest rate swaps which convert a portion of its fixed-rate debt into floating-rate debt. All of the Company's interest rate swaps meet the shortcut method requirements. Accordingly, changes in the fair values of the interest rate swaps are exactly offset by changes in the fair value of the underlying debt. No ineffectiveness has been recorded to net income related to interest rate swaps designated as fair value hedges for the three months ended March 31, 2012. A total of \$1.8 billion of the Company's outstanding fixed-rate debt was effectively converted to floating-rate debt resulting from the use of interest rate swaps.

Cash Flow Hedges

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The Company enters into cash flow hedges to reduce the exposure to variability in certain expected future cash flows. The types of cash flow hedges the Company enters into include interest rate swaps, foreign currency forwards and foreign currency options.

The Company periodically uses interest rate swaps to effectively convert a portion of floating-rate debt, including forecasted debt issuances, into fixed-rate debt and the agreements are intended to reduce the impact of interest rate changes on future interest expense. At March 31, 2012, none of the Company's anticipated debt issuances were effectively converted to fixed-rate resulting from the use of interest rate swaps.

To protect against the reduction in value of forecasted foreign currency cash flows (such as royalties denominated in foreign currencies), the Company uses foreign currency forwards and foreign currency options to hedge a portion of anticipated exposures.

When the U.S. dollar strengthens against foreign currencies, the decline in value of future foreign denominated royalties is offset by gains in the fair value of the foreign currency forwards and/or foreign currency options. Conversely, when the U.S. dollar weakens, the increase in the value of future foreign denominated royalties is offset by losses in the fair value of the foreign currency forwards and/or foreign currency options.

Although the fair value changes in the foreign currency options may fluctuate over the period of the contract, the Company's total loss on a foreign currency option is limited to the upfront premium paid for the contract. However, the potential gains on a foreign currency option are unlimited as the settlement value of the contract is based upon the difference between the exchange rate at inception of the contract and the spot exchange rate at maturity. In limited situations, the Company uses foreign currency collars, which limit the potential gains and lower the upfront premium paid, to protect against currency movements.

The hedges cover the next 15 months for certain exposures and are denominated in various currencies. As of March 31, 2012, the Company had derivatives outstanding with an equivalent notional amount of \$291.4 million that were used to hedge a portion of forecasted foreign currency denominated royalties.

The Company excludes the time value of foreign currency options, as well as the forward points on foreign currency forwards, from its effectiveness assessment on its cash flow hedges. As a result, changes in the fair value of the derivatives due to these components, as well as the ineffectiveness of the hedges, are recognized in earnings currently. The effective portion of the gains or losses on the derivatives is reported in the cash flow hedging component of OCI in shareholders' equity and reclassified into earnings in the same period or periods in which the hedged transaction affects earnings.

The Company recorded after tax adjustments to the cash flow hedging component of accumulated OCI in shareholders' equity. The Company recorded a net decrease of \$3.5 million for the three months ended March 31, 2012 and 2011. Based on interest rates and foreign exchange rates at March 31, 2012, the \$1.1 million in cumulative cash flow hedging gains, after tax, at March 31, 2012, is not expected to have a significant effect on earnings over the next 12 months.

Net Investment Hedges

The Company primarily uses foreign currency denominated debt (third party and intercompany) to hedge its investments in certain foreign subsidiaries and affiliates. Realized and unrealized translation adjustments from these hedges are included in shareholders' equity in the foreign currency translation component of OCI and offset translation adjustments on the underlying net assets of foreign subsidiaries and affiliates, which are also recorded in OCI. As of March 31, 2012, a total of \$4.8 billion of the Company's outstanding foreign currency denominated debt was designated to hedge investments in certain foreign subsidiaries and affiliates.

Credit Risk

The Company is exposed to credit-related losses in the event of non-performance by the counterparties to its hedging instruments. The counterparties to these agreements consist of a diverse group of financial institutions. The Company continually monitors its positions and the credit ratings of its counterparties and adjusts positions as appropriate. The Company did not have significant exposure to any individual counterparty at March 31, 2012 and has master agreements that contain netting arrangements. Some of these agreements also require each party to post collateral if credit ratings fall below, or aggregate exposures exceed, certain contractual limits. At March 31, 2012, neither the Company nor its counterparties were required to post collateral on any derivative position, other than on hedges of certain of the Company's supplemental benefit plan liabilities where its counterparties were required to post collateral on their liability positions.

Segment Information

The Company franchises and operates McDonald's restaurants in the global restaurant industry. The following table presents the Company's revenues and operating income by geographic segment. The APMEA segment represents operations in Asia/Pacific, Middle East and Africa. Other Countries & Corporate represents operations in Canada and Latin America, as well as Corporate activities.

In millions	Quarters Ended	
	March 31,	
	2012	2011
Revenues		
U.S.	\$ 2,102.3	\$ 1,925.8
Europe	2,535.5	2,440.0
APMEA	1,556.6	1,400.5
Other Countries & Corporate	352.2	345.3
Total revenues	\$ 6,546.6	\$ 6,111.6
Operating Income		
U.S.	\$ 871.3	\$ 793.0
Europe	699.3	675.3
APMEA	383.9	348.0
Other Countries & Corporate	10.1	9.6
Total operating income	\$ 1,964.6	\$ 1,825.9
Subsequent Events		

The Company evaluated subsequent events through the date the financial statements were issued and filed with the Securities and Exchange Commission. There were no subsequent events that required recognition or disclosure.

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

Overview