

**Consolidated Statements of Cash Flows**

**Cash flow from operating activities**

*Amounts in millions*

Net Earnings	12,736
Depreciation and amortization	3,108
Change in	
Accounts receivable	501
Total inventories	496
Deferred income taxes (Asset)	219
Prepaid expenses and other current assets	5
Accounts payable	1,271
Accrued and other liabilities	(42)
Deferred Income Taxes (Liability)	150
Other Noncurrent Liabilities	1,043
Accumulated other comprehensive income -loss)	(4,464)
Cash flow from operating activities	15,023

**Cash flow from investing activities**

Best                      Direct

Property, Plant and Equipment, purchased	(361)	218
Depreciation and amortization	(3,108)	(3,108)
Amortization of intangibles	601	601
Accumulated depreciation, net inc	579	
Accumulated depreciation, sold	(1,928)	(1,928)
Net Goodwill and Other Intangible Assets		
Ending - Beginning - Amortization of intangibles		
85648 - 89118 - 601 =	2,869	2,869
Other Noncurrent Assets	(150)	(150)
Cash flow from investing activities	430	430

**Cash flow from financing activities**

From BalSht

Debt due within one year	(7,848)
Long-Term Debt	708
Preferred Stock	(47)
Common stock, stated value \$1 per share (10,000	1
Additional paid-in capital	579
Reserve for ESOP debt retirement	(10)
Treasury stock	(5,348)
Non-controlling interest	41
Dividends =      Net Earnings - End RetEarn + Beg RetEarn	
12736 - 64614 + 57309	(5,431)
Cash flow from financing activities	(17,355)

**Increase in cash**

**(1,902)**

## Financial Statement Analysis

2 Shares outstanding = shares issued: 2010 - Treasury stock  
 a 4007.6 - 1164.1 2,844

	2010	2009	Average
Shareholders' Equity	61,439	63,382	
Non-controlling interest	324	283	
	61,115	63,099	
Preferred Stock	1,277	1,324	
Common Equity	59,838	61,775	60,807

Book Value per share 59838 ÷ 2844

**\$ 21.04**

b Net Earnings 10,946  
 Interest expense 946  
 Income taxes on continuing operations 4,101  
 EBIT 15,993

Interest expense reported 946  
 Capitalized interest 68  
 Interest expense 1,014

EBIT 15,993

**Times Interest Earned.** 15,993 ÷ 1,014

**15.7722**

c Margin before interest and taxes EBIT ÷ Net Sales  
 MBIT 15993 ÷ 78938

**20.26%**

xxx Effective Tax Rate 4,101 ÷ 15,047 = 27.25%

	2010	2009	Average
Debt due within one year	8,472	16,320	
Long-Term Debt	21,360	20,652	
d Total Debt	29,832	36,972	33,402
d Equity	61,115	63,099	62,107
Total Capital	90,947	100,071	95,509
d Total Assets	128172	134833	131,503
d Operating Liabilities	37225	34762	35,994

	2010	2009	Average
<b>Adjust for preferred stock</b>	1,277	1,324	1,301

Debt including preferred stock 33402 + 1301

**34,703**

Common Equity 62107 - 1301

**60,806**

## Financial Statement Analysis

<b>e</b>	EBIT(1-tax rate)	$15993 \cdot 0.7275$	=	11,635	
	OR =	Net income + (1-tax rate) • Interest expense			
	=	$10,946 + 0.7275 \cdot 946$	=	11,634	
	<b>ROA</b>	= EBIT(1-tax rate) ÷ Average assets			
		$11635 \div 131503$			<b>8.85%</b>
<b>f</b>	<b>Debt - to - Equity Ratio (D/E)</b>	Average debt ÷ Average Equity			
		$33402 \div 62107$			<b>0.5378</b>
	<b>Debt - to - Common Equity Ratio (D/CE)</b>	Average debt ÷ Average Common Equity			
		$34703 \div 60806$			<b>0.5707</b>
<b>g</b>	<b>Return on Equity (ROE)</b>	$10946 \div 62,107$			
		Net income ÷ Average equity			<b>17.62%</b>
	Net income to common	Net income - Preferred Dividends			
		$10946 - 192$	=	10,754	
	<b>Return on Common Equity</b>	Net income to common ÷ Average Common Equity			
		$10,754 \div 60,806$			<b>17.69%</b>
<b>h</b>	<b>Return on Total Capital</b>	$11,635 \div 95,509$			<b>12.18%</b>
	<b>ROTC</b>	EBIT(1-tax rate) ÷ Total Capital			
<b>XXX</b>	After tax cost of interest	$946 \cdot 0.7275$	=	688	
	After tax cost of interest (ATI Rate)	$688 \div 33,402$	=	2.06%	
	After tax cost of interest (with preferred)	$688 + 192$	=	880	
	After tax cost of interest (ATI Rate(P))	$880 \div 34,703$	=	2.54%	
	Operating Liabilities Leverage	$35,994 \div 95,509$	=	0.3769	
	OLLev				
<b>i</b>	<b>ROTC</b>	= ROA + OLLev x [ ROA - 0.0000 ]			
		$8.85\% + 0.3769 \times [ 8.85\% - 0.0000 ]$	=	12.18%	
<b>j</b>	<b>ROE</b>	= ROTC + D/E x [ ROTC - ATI Rate ]			
		$12.18\% + 0.5378 \times [ 12.18\% - 0.0206 ]$	=	17.63%	
	<b>ROCE</b>	= ROTC + D/CE x [ ROTC - ATI Rate(P) ]			
		$12.18\% + 0.5707 \times [ 12.18\% - 0.0254 ]$	=	17.69%	
<b>k</b>	<b>Asset turnover</b>	Net Sales ÷ Average assets			
	<b>ATO</b>	$78938 \div 131503$			<b>0.6003</b>
<b>l</b>	<b>ROA</b>	= MBIT • ATO (1-tax)			
		$8.85\% = 20.26\% \cdot 0.6002753 \cdot 0.7275$			

## Financial Statement Analysis

<b>3</b>	U.S. federal statutory income tax rate	35.00%	
<b>a</b>	Country mix impacts of foreign operations	<u>(7.50)%</u>	
	Marginal tax rate for the company	27.50%	
	Increase in deferred tax liability due fixed assets	1642 - 1654 =	(12)
	Tax Depreciation - Reported Depreciation	-12/0.275 =	(44)
	Amortization of intangibles		601
	Depreciation and amortization reported		3,108
	Depreciation for tax purposes	3108 - 44 - 601 =	<b>2,463</b>

**b** P & G faced lower tax rates in countries outside the U.S. as the effective tax rate was decreased due to foreign operations.

Earnings before income taxes, total			15047
Effect of international tax rates on effective tax rate			(7.50)%
Amount	(7.50)% • 15,047	=	(1,129)
Earnings before income taxes, international			6,679
International Tax at US rates	35.00% • 6,679	=	2,338
International taxes paid	2,338 - 1,129	=	1,209
International tax rate	1,209 ÷ 6,679	=	<b>18.10%</b>

<b>4</b>	From Deferred Tax Assets Note	2010	2009
<b>a</b>	Pension and postretirement benefits	1717	1,395
	Increase	322	
	Expense - Cash spent	= Increase ÷ Tax rate	
		= 322 ÷ 0.275	<b>1,171</b>

Pension benefits	4,701	3,798	OR
Other postretirement benefits	1,915	1,516	
	<u>6,616</u>	5,314	
Increase = Expense - Cash spent	1,302		<b>1,302</b>

<b>4</b>	Inflation Rate	= 5.00%	
<b>b</b>	LIFO adjustment	= Beg. Inventory (FIFO) • Inflation Rate	
		= 6880 • 0.05 =	344
	Net Income (LIFO)	= Net Income (as is) - LIFO adjustment • (1-tax rate)	
		= 12736 - 344 • 0.65	<b>12,512</b>
	As LIFO is allowed only in US, US rates are used.		

### Better

As inventories decrease LIFO adjustment			
=	End Inventory (FIFO) • Inflation Rate / (1+Inflation Rate)		
=	6384 • 0.0476 =	304	
Net Income (LIFO)	= Net Income (as is) - LIFO adjustment • (1-tax rate)		
	= 12736 - 304 • 0.65		<b>12,538</b>

# Cash Flow Reigns Once Again

## Analysis

1. What is free cash flow?

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*Free cash flow, a company's true profitability = operating cash flow – needed capital investments. Usually interest expense is added back  
Free cash flow can be used for acquisitions, payments to investors or keep for future use.*

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2. How does free cash flow differ from operating cash flow?

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*Free cash flow, subtracts amount =needed to maintain productive capacity.*

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3. Why can net income be a less reliable measure of performance than free cash flow or operating cash flow? Give some additional means that companies can use other than those mentioned in the article.

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*Net income can be manipulated with accounting methods and changes in assumptions and estimates.  
Accruals are an easy way to manage earnings.  
- Change bad debt percentages, change inventory accounting methods, change depreciation methods.*

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4. Might a firm's value rise when its free cash flow drops? Explain.

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*YES.  
If they invest in R & D, advertise, invest in new technology etc.*

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5. How might a firm manipulate free cash flow to give a false impression of performance?

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*Hold off on paying some accounts payable.  
Cut capital spending and R & Division etc.  
Lease instead of buying.  
Sell Accounts Receivables to SPE's*

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