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Open Book and Notes

Mid-Term Exam

March 10, 2011
 Thursday

Show all your work in the answer sheets. You will not get credit for a right answer unless you show all the steps in these sheets. As a courtesy to fellow test takers, please turnoff all pagers, telephones and PDA's.

<i>Case</i>	<i>Pages</i>	<i>Question</i>	<i>Points Estimated Time</i>	
Procter & Gamble	13	Question	125	
		1	50	<input type="text"/>
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Cash Flow Reigns Once Again	3		25	<input type="text"/>
Total	16		150	<input type="text"/>

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Signature

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From **PROCTER & GAMBLE CO (PG)**
 10-K Annual report pursuant to section 13 and 15(d)
 Filed Period 06/30/2010



The Procter & Gamble Company is focused on providing branded consumer packaged goods of superior quality and value to improve the lives of the world's consumers. The Company was incorporated in Ohio in 1905, having been built from a business founded in 1837 by William Procter and James Gamble. Today, we market our products in more than 180 countries.

Key Product Categories. In 2010, two product categories accounted for 10% or more of consolidated net sales. The laundry category constituted approximately 17% of net sales for fiscal years 2010, 2009 and 2008. The diaper category constituted approximately 11% of net sales for fiscal years 2010 and 2009 and 10% in 2008.

Key Customers. Our customers include mass merchandisers, grocery stores, membership club stores, drug stores and high-frequency stores. Sales to Wal-Mart Stores, Inc. and its affiliates represent approximately 16% of our total revenue in 2010, 2009 and 2008. No other customer represents more than 10% of our net sales. Our top ten customers account for approximately 32% of our total unit volume in 2010, compared to 30% of total unit volume in 2009 and 31% in 2008. The nature of our business results in no material backlog orders or contracts with the government. We believe our practices related to working capital items for customers and suppliers are consistent with the industry segments in which we compete.

The Procter & Gamble Company Consolidated Statements of Earnings

Amounts in millions except per share amounts

Years ended June 30	2010	2009	2008
Net Sales	78,938	76,694	79,257
Cost of products sold	37,919	38,690	39,261
Selling, general and administrative expense	24,998	22,630	24,017
Operating Income	16,021 #	15,374 #	15,979
Interest expense	946	1,358	1,467
Other non-operating income/(expense), net	(28)	397	373
Earnings from Continuing Operations before Taxes	15,047	14,413	14,885
Income taxes on continuing operations	4,101	3,733	3,594
Net Earnings from Continuing Operations	10,946 #	10,680 #	11,291
Net Earnings from Discontinued Operations	1,790	2,756	784
Net Earnings	12,736 #	13,436 #	12,075

Basic Net Earnings Per Common Share:

Earnings from continuing operations	\$3.70	\$3.55	\$3.61
Earnings from discontinued operations	\$0.62	\$0.94	\$0.25
Basic Net Earnings Per Common Share	\$4.32	\$4.49 #	\$3.86

Diluted Net Earnings Per Common Share:

Earnings from continuing operations	3.53	3.39	3.4
Earnings from discontinued operations	0.58	0.87	0.24
Diluted Net Earnings Per Common Share	\$4.11	\$4.26 #	\$3.64

The Procter & Gamble Company Consolidated Balance Sheets

Amounts in millions; June 30

Assets

Cash and cash equivalents	2,879	4,781	(1,902)
Accounts receivable	5,335	5,836	(501)
Inventories			
Materials and supplies	1,692	1,557	135
Work in process	604	672	(68)
Finished goods	4,088	4,651	(563)
Total inventories	6,384	6,880	(496)
Deferred income taxes	990	1,209	(219)
Prepaid expenses and other current assets	3,194	3,199	(5)
Total Current Assets	18,782	21,905	(3,123)
Buildings	6,868	6,724	144
Machinery and equipment	29,294	29,042	252
Land	850	885	(35)
Total property, plant and equipment	37,012	36,651	361
Accumulated depreciation	(17,768)	(17,189)	(579)
Net Property, Plant and Equipment	19,244	19,462	(218)
Goodwill	54,012	56,512	(2,500)
Trademarks and other intangible assets, net	31,636	32,606	(970)
Net Goodwill and Other Intangible Assets	85,648	89,118	(3,470)
Other Noncurrent Assets	4,498	4,348	150
Total Assets	128,172	134,833	(6,661)

Liabilities and Shareholders' Equity

Accounts payable	\$ 7,251	\$ 5,980	1,271
Accrued and other liabilities	8,559	8,601	(42)
Debt due within one year	8,472	16,320	(7,848)
Total Current Liabilities	24,282	30,901	(6,619)
Long-Term Debt	21,360	20,652	708
Deferred Income Taxes	10,902	10,752	150
Other Noncurrent Liabilities	10,189	9,146	1,043
Total Liabilities	66,733	71,451	(4,718)
Convertible Class A preferred stock, stated value \$1 pe	1,277	1,324	(47)
Common stock, stated value \$1 per share (10,000 shares authorized; shares issued: 2010 — 4,007.6, 2009 — 4,007.3)	4,008	4,007	1
Additional paid-in capital	61,697	61,118	579
Reserve for ESOP debt retirement	(1,350)	(1,340)	(10)
Accumulated other comprehensive income -loss)	(7,822)	(3,358)	(4,464)
Treasury stock, at cost -shares held: 2010 — 1,164.1, 2009 — 1,090.3)	(61,309)	(55,961)	(5,348)
Retained earnings	64,614	57,309	7,305
Non-controlling interest	324	283	41
Shareholders' Equity	61,439	63,382	(1,943)
Total Liabilities and Shareholders' Equity	\$ 128,172	134,833	(6,708)

NOTE 1**Summary of Significant Accounting Policies**

Amounts in millions

Capitalized interest in year ended June 30, 2010 was \$68.

NOTE 2**Goodwill and Intangible Assets**

The amortization of intangible assets was as follows:

Years ended June 30	2010	2009	2008		
Intangible Asset Amortization	\$ 601	\$ 648	\$ 649		
Estimated amortization expense over the next five years is as follows:					
Years ended June 30	2011	2012	2013	2014	2015
Estimated Amortization Expense	530 \$	490 \$	470 \$	434 \$	401

Such estimates do not reflect the impact of future foreign exchange rate changes.

There was no goodwill impairment.

The Procter & Gamble Company

Consolidated Statements of Shareholders' Equity

	Common Shares Out-standing	Common Stock	Preferred Stock	Additional Paid-In Capital	Reserve for ESOP Debt p- Retirement	accumulated Other Income	Non- controlling Interest	Treasury Stock	Retained Earnings	Total
Balance June 30, 2009	2,917,035	4,007	1,324	61,118	(1,340)	(3,358)	283	(55,961)	57,309	63,382
Net earnings									12,736	12,736
Other comprehensive income:										
Financial statement translation						(4,194)				(4,194)
Hedges and investment securities, net of \$520 tax						867				867
Defined benefit retirement plans, net of \$465 tax						(1,137)				(1,137)
Total comprehensive income										
Common Dividends to shareholders:									(5,239)	(5,239)
Preferred Dividends, net of tax benefits									(192)	(192)
Treasury purchases	(96,759)							(6,004)		(6,004)
Employee plan issuances	17,616	1		574				616		1,191
Preferred stock conversions	5,579		(47)	7				40		0
ESOP debt impacts					(10)					(10)
Noncontrolling interest				(2)			41			39
BALANCE JUNE 30, 2010	2,843,471	4,008	1,277	61,697	(1,350)	(7,822)	324	(61,309)	64,614	61,439

Note 9**Income Taxes**

Income taxes are recognized for the amount of taxes payable for the current year and for the impact of deferred tax liabilities and assets, which represent future tax consequences of events that have been recognized differently in the financial statements than for tax purposes. Deferred tax assets and liabilities are established using the enacted statutory tax rates and are adjusted for any changes in such rates in the period of change.

Earnings from continuing operations before income taxes consisted of the following:

Years ended June 30	2010	2009	2008
United States	8,368	8,409	8,167
International	6,679	6,004	6,718
TOTAL	15,047 #	14,413	14,885

A reconciliation of the U.S. federal statutory income tax rate to our actual income tax rate on continuing operations is provided below:

Years ended June 30	2010	2009	2008
U.S. federal statutory income tax rate	35.00 %	35.00 %	35.00 %
Country mix impacts of foreign operations	(7.50) %	(7.10) %	(6.80) %
Income tax reserve adjustments	(0.40) %	(1.30) %	(3.40) %
Patient Protection and Affordable Care Act	1.00 %	%	%
Other	(0.80) %	(0.70) %	(0.70) %
EFFECTIVE INCOME TAX RATE	27.30 %	25.90 %	24.10 %

In March 2010, the Patient Protection and Affordable Care Act (PPACA) was signed into law. One of the provisions of the PPACA changed the taxability of federal subsidies received by plan sponsors that provide retiree prescription drug benefits at least equivalent to Medicare Part D coverage. as a result of the change in taxability of the federal subsidy, we were required to make adjustments to deferred tax asset balances, resulting in a \$152 charge to income tax expense.

Deferred income tax assets and liabilities were comprised of the following:

DEFERRED TAX ASSETS	June 30	2010	2009
Pension and postretirement benefits	\$	1,717	\$ 1,395
Stock-based compensation		1,257	1,182
Loss and other carry forwards		595	439
Goodwill and other intangible assets		312	331
Accrued marketing and promotion		216	167
Fixed assets		102	114
Unrealized loss on financial and foreign exchange tran:		88	577
Accrued interest and taxes		88	120
Advance payments		16	15
Inventory		35	97
Other		757	885
Valuation allowances		(120)	(104)
TOTAL		5,063	5,218

DEFERRED TAX LIABILITIES

Goodwill and other intangible assets		11,760	11,922
Fixed assets		1,642	1,654
Other		269	146
TOTAL		13,671	13,722

NOTE 3

Supplemental Financial Information

Selected components of current and noncurrent liabilities were as follows:

Accrued and Other Liabilities — Current

Marketing and promotion	2,857	2,378
Compensation expenses	1,822	1,983
Taxes payable	622	722
Other	3,258	3,518
TOTAL	8,559	8,601

Other Noncurrent Liabilities

Pension benefits	4,701	3,798
Other postretirement benefits	1,915	1,516
Uncertain tax positions	2,381	2,705
Other	1,192	1,127
TOTAL	10,189	9,146

Note 12 Segment Information

Under U.S. GAAP, we have six reportable segments: Beauty; Grooming; Health Care; Snacks and Pet Care; Fabric Care and Home Care; and Baby Care and Family Care. the accounting policies of the businesses are generally the same as those described in Note 1. Differences between these policies and U.S. GAAP primarily reflect income taxes, which are reflected in the businesses using applicable blended statutory rates, and the treatment of certain unconsolidated investees. Certain unconsolidated investees are managed as integral parts of our business units for management reporting purposes. Accordingly, these partially owned operations are reflected as consolidated subsidiaries in segment results, with full recognition of the individual income statement line items through before-tax earnings. Eliminations to adjust these line items to U.S. GAAP are included in Corporate. in determining after-tax earnings for the businesses, we eliminate the share of earnings applicable to other ownership interests, in a manner similar to non-controlling interest and apply statutory tax rates. Adjustments to arrive at our effective tax rate are also included in Corporate.

Corporate includes certain operating and non-operating activities that are not reflected in the operating results used internally to measure and evaluate the businesses, as well as eliminations to adjust management reporting principles to U.S. GAAP. Operating activities in Corporate include the results of incidental businesses managed at the corporate level along with the elimination of individual revenues and expenses generated by certain unconsolidated investees discussed in the preceding paragraph over which we exert significant influence, but do not control. Operating elements also include certain employee benefit costs, the costs of certain restructuring-type activities to maintain a competitive cost structure, including manufacturing and workforce rationalization and other general Corporate items. the non-operating elements in Corporate primarily include interest expense, divestiture gains and interest and investing income. in addition, Corporate includes the historical results of certain divested businesses.

Total assets for the reportable segments include those assets managed by the reportable segment, primarily inventory and fixed assets. Other assets, primarily including cash, accounts receivable, investment securities and goodwill, are included in Corporate.

The Company had net sales in the U.S. of \$30.0 billion, \$29.6 billion and \$29.7 billion for the years ended June 30, 2010, 2009 and 2008, respectively. Assets in the U.S. totaled \$70.1 billion and \$71.9 billion as of June 30, 2010 and 2009, respectively.

Our largest customer, Wal-Mart Stores, Inc. and its affiliates, accounted for 16% of consolidated net sales in 2010, 2009 and 2008.

Global Segment Results		Net Sales	Earnings let from Continuing Operations Before Taxes	Earnings from Continuing Operations	Depreciation and Amortization	Total Assets(2)	Capital xpenditures
Beauty	2010	19,491	3,648	2,712	503	11,825	\$ 534
	2009	18,924	3,558	2,664	454	11,987	526
	2008	19,666	3,673	2,827	450	12,760	462
Grooming	2010	7,631	2,007	1,477	625	21,259	259
	2009	7,408	1,900	1,359	721	22,205	294
	2008	8,103	2,154	1,582	743	23,302	308
Health Care	2010	11,493	2,809	1,860	385	7,142	383
	2009	11,288	2,786	1,835	369	7,206	372
	2008	12,087	3,030	2,021	372	8,088	420
Snacks and Pet Care	2010	3,135	499	326	92	1,237	86
	2009	3,114	388	234	100	1,123	72
	2008	3,204	409	261	102	1,303	78
Fabric Care and Home Care	2010	23,805	5,076	3,339	604	9,650	766
	2009	23,186	4,663	3,032	578	10,419	808
	2008	23,714	5,060	3,411	599	11,387	763
Baby Care and Family Care	2010	14,736	3,270	2,049	612	6,406	852
	2009	14,103	2,827	1,770	570	6,259	902
	2008	13,898	2,700	1,728	612	6,821	763
Corporate(1)	2010	(1,353)	(2,262)	(817)	287	70,653	187
	2009	(1,329)	(1,709)	(214)	224	75,634	264
	2008	(1,415)	(2,141)	(539)	181	80,331	252
Total Company	2010	78,938	15,047	10,946	3,108	128,172	3,067
	2009	76,694	14,413	10,680	3,016	134,833	3,238
	2008	79,257	14,885	11,291	3,059	143,992	3,046

(1) the Corporate reportable segment includes the total assets and capital expenditures of the coffee and pharmaceuticals businesses prior to their divestitures in November 2008 and October 2009, respectively.

(2) Prior years' total assets have been updated to reflect a change in management accountability for certain items, primarily accounts receivable, from the reportable segments to Corporate.

Amounts in millions of dollars except per share amounts or as otherwise specified.

1 Consolidated Statements of Cash Flows

Construct the Consolidated Statements of Cash Flows for Proctor and Gamble for the year ending 6/30/10 using the indirect method. for your convenience, the increases in all balance sheet accounts are also given.

- 2 For all financial analysis, use only "Net Earnings from Continuing Operations".
Equity hereafter refers only to common equity.
It does not include preferred equity or non-controlling interests.

- a Book Value per share as of 6/30/2010.
Note that book value per share is only for common equity.

- b Times Interest Earned. (for year ending 6/30/2010)

- c Margin before interest and taxes (for year ending 6/30/2010).
MBIT

d

Average debt (for year ending 6/30/2010).

Average Equity (for year ending 6/30/2010).

Average Assets for year ending 6/30/2010).

Average Operating Liabilities (for year ending 6/30/2010).

e Return on assets (after tax, for year ending 6/30/2010).

f Average Debt - to - equity ratio (for year ending 6/30/2010)

g Return on Equity (for year ending 6/30/2010).

h Return on Total capital (for year ending 6/30/2010).

i Show how you can derive ROTC from ROA

j Show how you can derive ROE from ROTC.

k Asset turnover (for year ending 6/30/2010).
ATO

l Show how you can derive ROA from MBIT and ATO.

- 3** How much depreciation expense on property (fixed assets) did P & G count for
- a** tax purposes for the year ending 6/30/10? Use information in the tax note where the increase in deferred taxes due to fixed assets depreciation is given. Note that goodwill amortization can never be deducted for tax purposes.

- b** What was the average international tax rate faced by P & G in the year ending 6/30/2010?

- 4** In the year ending 6/30/2010, how much more did P&G expense for
- a** "Pension and postretirement benefits" compared to the amount paid out in cash for "Pension and postretirement benefits"?

- b** How much will the net income of P & G for the year ending 6/30/10 be if it uses Last in First Out (LIFO) method for all its inventories?
Assume that the average inflation rate for P & G is 5%.

| THE WALL STREET JOURNAL |

By TOM LAURICELLA May 12, 2008; Page C1

Cash is King
Performance of S&P 500 companies ranked by median free-cash-flow yield

Quintile	Free cash flow yield*	Compound total return†
Top 20%	+9.7%	-4.0%
	+5.0	-3.5
	+2.6	-1.8
	-1.5	-3.2
Bottom 20%	-45.5	-10.5

*52-weeks through May 5 †Year to date
Source: Loomis Sayles

When sizing up stocks in uncertain times, it's best to follow the cash.

Last week's stock-market swoon showed how unsettled the investing landscape remains. As a result, earnings quality is coming into focus among some investment pros. When so many things can go wrong, they want to know that a dollar earned is really a dollar earned. And corporate cash flows are an important gauge of the quality of earnings.

Headline earnings numbers -- typically net income -- can be massaged by perfectly legal accounting tricks, such as changing depreciation schedules or the way revenue is recognized. Cash flows -- how much actual money a company spits out -- are by no means immune from shenanigans, but many analysts consider them a cleaner way to assess a company's health.

There are other reasons to search out companies with strong cash flow. A company generating extra cash can avoid the costly proposition of raising money in today's unsteady markets. It also gives companies the flexibility to boost dividends or stock buybacks.

Operating cash flow is the amount of cash a company creates from its operations, unvarnished by earnings that come from things like asset sales. Free cash flow -- considered an even purer measure of a company's true profitability -- subtracts from operating cash flow the money going into capital investments. It's "as close as there is to a silver bullet when it comes to sorting out good companies from the pretenders," says David Sowerby, a portfolio manager at Loomis Sayles & Co.

Mr. Sowerby tracks free-cash-flow yield, or a company's free cash flow divided by its shares outstanding. He likes Hewlett-Packard Co. The computer and printer maker sports a free-cash-flow yield that is double that of the Standard & Poor's 500-stock index's 4% and has seen its cash flow grow by more than 30% over the past three years. H-P's shares are down 2.5% this year, but they are up some 9% in the past 12 months.

Among companies with weak cash flow is Goodyear Tire & Rubber Co. Its earnings are expected to grow 80% this year, according to Thomson Reuters. But its cash flow has been negative in part due to heavy capital expenditures. The stock is flat in 2008 and down 16% in the past year.

Cash flow isn't a new idea on Wall Street. In the past, some consultants and Wall Street firms turned it into a fad and even marketed variations of the idea as a measure of business performance.

It also isn't a perfect yardstick. Companies can goose cash flows even when it's not in their interest. For example, they might cut needed capital spending to hoard cash and in turn jeopardize future growth.

Lately, investors have focused more on other stock attributes, like a "momentum" approach. There, they buy stocks that are already going up and sell or avoid those that are falling. Lehman Brothers' quantitative-investing group says a price-momentum strategy has been one of its best performers this year, with a 2.5% gain.

But that could soon change.

"When we get into an environment where investors are willing to dip their toe into the water and go out a little bit more on the risk spectrum, the place that they're going to start dipping is in the

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Cash Flow Reigns Once Again 2

high-quality names," says Matthew Rothman, global head of quantitative-equity strategies at Lehman.

Mr. Rothman says there are hints that quality is starting to matter more. Another Lehman strategy is one that screens stocks based on changes in their accruals -- things like unpaid bills or accounts receivable. It bets against stocks with rising accruals -- a signal cash flow might not be so healthy -- and favors stocks that generate operating cash. That strategy is up 5.6% so far this year, Lehman says, in part because it generally avoids financials.

Richard Sloan, of Barclays Global Investors, expects to see more strains on companies with rising accruals, especially those that have put large amounts of "goodwill" on their balance sheets in recent years that reflect the premiums they paid over book values in acquisitions.

Mr. Sloan points to General Electric Co., which shocked investors recently with weaker-than-expected earnings. He said GE experienced a growing gap between net income and cash flow. "That suggested the company had been stretching to meet its numbers," he says.

William Priest, chief investment officer of Epoch Investment Partners, favors cable company Comcast Corp., which is up 19% this year. It had \$2.3 billion in free cash flow in 2007 and initiated a quarterly dividend earlier this year, while also committing to buying back nearly \$7 billion worth of stock by the end of 2009.

Mr. Priest also likes Davita Inc., which provides dialysis services. It has had strong earnings growth coupled with healthy free-cash-flow gains over the years. Last week, the company announced an increase in its share-repurchase program. The stock is down 8% so far this year.

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Hyperlinks in this Article: (1) <mailto:tom.lauricella@wsj.com>

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Questions:

1. What is free cash flow?
2. How does free cash flow differ from operating cash flow?
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 to manage earnings other than those mentioned in the article.
4. Might a firm's value rise when its free cash flow drops? Explain.
5. How might a firm manipulate free cash flow to give a false impression of performance?