General Mills Inc.—Understanding Financial Statements

Teaching Notes:

This is the first case we use in our course and it sets the tone. We find that using a company well-known to students piques their interest and gets the course off to a good start. The purpose of the case is to gain familiarity with financial statements and to begin to think about how financial statements reflect economic events and financial performance.

Some students need to be reminded that the point of the exercise is not to perform a comprehensive analysis of the company. At this point, most students do not have the required skills. Rather, the goal is one of discovery. Many students find that they understand a lot more of the information in the financials than they thought they would. Others find that the vocabulary bogs them down. They need to be encouraged to learn the language of business. A productive exercise is to have students jot down a few (3-5) items they find puzzling in the financial statements. Then, on the last day of class, have the students refer back to their list. Typically, they understand everything they had on their day-one list. This provides tangible evidence of the value of the course because most students are pleasantly surprised at how much they have learned.

The case probes the three basic statements as well as the two opinions issued by the firms' auditors. This provides the opportunity to introduce the notions of corporate governance and ethics.

The case includes basic questions to encourage students to dig into each financial statement for a look at the information they contain. The case also requires students to produce common-size income statements and balance sheets as a first stage of financial statement analysis of the statements.

For many students, the most eye-opening part of the case is the last part where they are asked to identify as many of the estimates underlying the financials as they can. Many are surprised to find out that financial statements are not "truth and beauty" but rather are the end result of a series of complex professional judgments. Understanding the role of judgment early on helps students place the rest of the cases in an appropriate perspective.

Note: the question on revenue recognition (question h.i.) may be too challenging to students with no accounting background and instructors may choose to omit this question.

This case can be used in conjunction with "Nordstrom – Analyzing Financial Performance" which follows up with simple operating ratio analysis. We have included two versions of the Analyzing case – one uses the traditional multiplicative DuPont decomposition, the other uses the return on net operating assets (RNOA) decomposition. Using the General Mills and Nordstrom cases together allows students to grapple with various financial statement items and terminology and then follow up with using the information to calculate and evaluate ratios but at a fairly basic level. The message is that we can use financial statements and ratios to better understand the firm's business and *operating results*. The two cases can be used back to back or the second case can be used at the end of the semester as a capstone case.

General Mills Inc.—Understanding Financial Statements

a. General Mills, Inc. sells food products throughout the United States. Major food product categories are ready-to-eat cereals, meals, frozen dough products, baking products, snacks, yogurt and organic foods. The company has an international segment that does retail business in Canada, Europe, Latin America and the Asia/Pacific region. The company sells via wholesalers and to retailers. The industry is very competitive, switching costs are low, brand loyalties are short term, and margins are razor thin. The company relies on new product development and aggressive marketing to generate profits.

b. The four commonly prepared financial statements are the income statement, the balance sheet, the cash flow statement and the statement of shareholders' equity. General Mills uses the following names to describe the statements: Consolidated Statements of Earnings, Consolidated Balance Sheets, Consolidated Statements of Cash Flows and Consolidated Statements of Stockholders' Equity and Comprehensive Income. In the United States, beginning in 1998, companies are required to report and display comprehensive income. Most U.S. companies report comprehensive income as part of one of the four commonly prepared financial statements – often similar to the General Mills combined Statement of Stockholders' Equity and Comprehensive Income.
"Consolidated" refers to the fact that General Mills' subsidiary companies are included in the financial statements. That is, all the companies owned by General Mills are part of a consolidated group for which one set of financial reports is prepared.

c. U.S. public companies are regulated by the Securities and Exchange Commission (SEC). SEC registrants must file quarterly financial statements. These quarterly statements (10-Q's for Q1 – Q3 and 10-K for Q4) are publicly available at www.sec.gov via the SEC's EDGAR system (EDGAR stands for electronic data gathering, analysis, and retrieval).

d. General Mills' management is responsible for both the financial statements and the company's internal controls. The financial statements include a Report of Management Responsibilities signed by the CEO and the CFO acknowledging that they are responsible for the financials. Also, beginning in 2002, CEOs and CFOs are required to certify the accuracy of their periodic (quarterly and annual) filings with an SEC filing.

There are many users of General Mills' financial statements, including: current and potential shareowners, current and potential debt investors, debt and equity analysts, competitors, suppliers, customers, government agencies such as the tax authorities and the SEC, labor unions, management, employees who contribute to General Mills' retirement funds, and accounting students such as yourself. The information these users desire is comprehensive - ranging from overall operating performance and profitability to growth trends and opportunities to information about sources and uses of cash to assess liquidity, solvency and overall risk. The wide variety of users and the information they seek led to the requirement that firms provide a General Purpose Financial Statement to meet the needs of many users in a comprehensive, uniform and credible manner.

e. KPMG LLP, a public accounting firm, audits the General Mills financial statements. KPMG issued two opinion letters. First, the auditors examined General Mills' internal control systems and found they were effective – they issued a two-part opinion: "In our opinion, management's assessment that General Mills maintained effective internal control over financial reporting… is fairly stated……." and "In our opinion, General Mills maintained, in all material respects, effective internal control…."

Second, KPMG issued an audit opinion about the company's financial statements themselves. KPMG gave General Mills an *unqualified* opinion. This is the best report a company can receive from its auditors. It means that the auditors have performed their tests and are reasonably sure that the financial statements are in compliance with Generally Accepted Accounting Principles. Note that it *does not* mean that the auditors guarantee that the financial statements are free from all misstatements or that the company is a good investment. They are merely saying that the numbers, as reported, can be relied upon to reflect General Mills' performance and financial position using GAAP rules.

The reports are dated July 27, 2006 because that is the date the auditors' field-work ended. In other words, the audits took place, in part, during the eight weeks after year-end.

f. Common-size financial statements:

GENERAL MILLS, INC. AND SUBSIDIARIES

COMMON-SIZE CONSOLIDATED STATEMENTS OF EARNINGS

	2006 $	2006 %	2005 $	2005 %
Net Sales	$11,640	100.0%	$11,244	100.0%
Cost of sales	6,966	59.8%	6,834	60.8%
Gross profit	4,674	40.2%	4,410	39.2%
SG&A	2,678	23.0%	2,418	21.5%
Interest, net	399	3.4%	455	4.0%
Restructuring and other	30	0.3%	84	0.7%
Divestitures (gain)	-	0.0%	(499)	-4.4%
Debt repurchase costs	-	0.0%	137	1.2%
Total costs & expenses	10,073	86.5%	9,429	83.9%
Earnings before income taxes and JV earnings	1,567	13.5%	1,815	16.1%
Income taxes	541	4.6%	664	5.9%
After-tax JV earnings	64	0.5%	89	0.8%
Net Earnings	$1,090	9.4%	$1,240	11.0%

GENERAL MILLS, INC. AND SUBSIDIARIES
COMMON-SIZE CONSOLIDATED BALANCE SHEETS

ASSETS	**2006 $**	**2006 %**	**2005**	**2005 %**
Cash and cash equivalents	$647	3.6%	$573	3.2%
Receivables	1,076	5.9%	1,034	5.7%
Inventories	1,055	5.8%	1,037	5.7%
Prepaid expenses and other	216	1.2%	203	1.1%
Deferred income taxes	182	1.0%	208	1.2%
Total Current Assets	3,176	17.4%	3,055	16.9%
Land, Buildings & Equipment	2,997	16.5%	3,111	17.2%
Goodwill	6,652	36.5%	6,684	37.0%
Other Intangible Assets	3,607	19.8%	3,532	19.6%
Other Assets	1,775	9.7%	1,684	9.3%
Total Assets	$18,207	100.0%	$18,066	100.0%
LIABILITIES AND EQUITY				
Accounts payable	$1,151	6.3%	$1,136	6.3%
Current portion of LT debt	2,131	11.7%	1,638	9.1%
Notes payable	1,503	8.3%	299	1.7%
Other current liabilities	1,353	7.4%	1,111	6.1%
Total Current Liabilities	6,138	33.7%	4,184	23.2%
Long-term Debt	2,415	13.3%	4,255	23.6%
Deferred Income Taxes	1,822	10.0%	1,851	10.2%
Other Liabilities	924	5.1%	967	5.4%
Total Liabilities	11,299	62.1%	11,257	62.3%
Minority Interests	1,136	6.2%	1,133	6.3%
Stockholders' Equity:				
Common stock	50	0.3%	50	0.3%
Additional paid-in capital	5,737	31.5%	5,691	31.5%
Retained earnings	5,107	28.0%	4,501	24.9%
Common stock in treasury	(5,163)	-28.4%	(4,460)	-24.7%
Unearned compensation	(84)	-0.5%	(114)	-0.6%
Accumulated other comprehensive income	125	0.7%	8	0.0%
Total Stockholders' Equity	5,772	31.7%	5,676	31.4%
Total Liabilities & Equity	$18,207	100.0%	$18,066	100.0%

g. i. The accounting equation holds for 2006 (in millions): $18,207 (Assets) = $11,299 (Liabilities) + $6,908 (Stockholders' equity $5,772 + Minority interest $1,136).

g. ii. General Mills' major assets include Goodwill (36.5% of total), Other Intangible Assets (19.8% of total), and Land, Buildings and Equipment, net (16.5% of total assets). The short-term (current) assets account for 17% of total assets while long-term assets comprise the remaining 83%. It is logical that much of General Mills' balance sheet would include long-term assets such as tangible fixed assets (plant and land are the fixed assets the company uses to produce inventory and run corporate operations) and intangible assets such as goodwill and other intangibles (e.g., patents and product brand names) resulting from acquisitions of other companies and their brands.

g. iii. An intangible asset is something of value that is not physical in nature. Examples include intellectual property (such as patents, copyrights, trademarks), human capital and brand value. As Note 1 of the General Mills financial statements states, “Goodwill represents the difference between the purchase prices of acquired companies and the related fair values of the (identifiable) net assets acquired.” Goodwill thus captures the value of the intangible assets of the companies that General Mills acquired. Given that General Mills has acquired a number of companies with valuable brands in the past, we would expect that the balance sheet would reflect a fairly high value of goodwill. Other intangible assets on the General Mills balance sheet include acquired brands and acquired patents. The value of intangible assets created internally is not reflected on the balance sheet under Generally Accepted Accounting Principles – rather, these expenditures are immediately expensed as they are incurred.

g. iv. General Mills has financed its assets with significant long-term debt: non-owners have financed 32.7% of total assets if we include both the debt due next year (23.6%) and that due in subsequent years (9.1%). The company has earned and retained significant profits, which is a form of internal financing. Interestingly, the lion’s share of the cash that General Mills received from selling common stock (31.8% of total assets) has been returned to shareholders with stock buy backs (24.7%).

h. i. Note 1 discusses revenue recognition issues for General Mills. Revenue is recorded when shipments are accepted by customers. This policy is consistent with GAAP revenue recognition as these transactions are “substantially complete” when customers accept and take possession of the merchandise. Sales are reflected net of estimated customer discounts such as coupons and trade promotions. These net amounts are the agreed upon sales prices and are expected to be collected within the terms of the sale. While General Mills does not allow for returns, returns are recorded as reductions to selling prices when they occur. The reporting of sales net of estimated reductions in selling price and returns is consistent with US GAAP and International Financial Reporting Standards.

h. ii. General Mills’ biggest expense is Cost of sales. About 60% of every dollar of sales goes to pay for the cost of manufacturing and packaging the product. The second largest expense is SG&A (average 22% of sales). The company has a large sales force and must pay for significant national advertising expenses. SG&A also includes depreciation, insurance, rent and other expenses required to run a multi-national company the size of General Mills.

h. iii. Focusing on the two key components of operating costs, the common-size income statement shows that Cost of sales declined by 1 percentage point from 60.8% to 59.8% yielding a similar increase in gross profit. Offsetting this improvement was a 1.5 percentage point increase in SG&A costs.

h. iv. These are not ordinary selling, general and administrative expenses so rolling them into SG&A could have been misleading. More importantly, the majority of these costs are one-time items so the company wants financial report users to make that distinction. Profits are higher in 2006 because of these one-time items.

h. v. General Mills was profitable in 2006 generating $1,090 million in after tax profit. In 2005, the company was also profitable and reported $1,240 million in profit after tax. Here profit means that net sales are greater than all the expenses for the year. A more refined profitability measure would involve ratios, which are scale free and thus permit more accurate comparisons among years.

h. vi. The percentage change in reported Net earnings is:

2005 to 2006:	-12.1%	= ($1,090 – $1,240)/$1,240
2004 to 2005:	+17.5%	= ($1,240 – $1,055)/$1,055

The percentage change in Net earnings adjusted for 'one-time items of Divestitures and Debt repurchase costs:

2005 to 2006:	+7.2%	= ($1,090 – $1,017[1])/$1,017
2004 to 2005:	-3.6%	= ($1,017 – $1,055)/$1,055

[1]Adjusted Net earnings in 2006:
= $1,240–[($499 - $137)×(1 – marginal tax rate)]
= $1,240 – ($362 × (1 - 0.383)
= $1,240 – $223
= $1,017

i. i. General Mills generated $1,771 million in Cash from operations compared to $1,090 million in Net earnings. Two key reconciling items between Cash from operations and Net earnings are non-cash depreciation and amortization expense of $424 million and the sum of the net increase in non-cash working capital accounts ($184 million), which reflects the net increase in the cash required to support operations.

i. ii. General Mills used $360 million in cash to purchase land, building and equipment.

i. iii. General Mills paid total cash dividends of $485 million.

j. Here are *just a few* of the accounts requiring estimates and professional judgment to determine their balance.

Receivables, net (of allowance for doubtful accounts) The allowance is an *estimate* of the amounts included in accounts receivable which may not be collected in the future.

Inventory General Mills counts its inventory on a test basis at year end and then assigns a cost estimate for its value. Under U.S. GAAP, if the inventory falls below market value or become obsolete, the company needs to estimate a provision for the amount of the decline in value or the amount of obsolete inventory.

Fixed assets (land, buildings, vehicles, fixtures, computers) General Mills reports fixed assets net of accumulated depreciation. Annual depreciation expense is a calculated amount based on a method selected by management and involves estimates of asset useful life and salvage value.

Accrued liabilities These represent General Mills' best estimate at year end of amounts they owe for bills they have not yet received or have not yet paid. This is a big estimate.

With the exception of cash and long-term debt, virtually all accounts making up the financial statements involve estimates. This makes the financials quite subjective and users must be aware of this attribute and the nature of the estimation involved with each line-item.