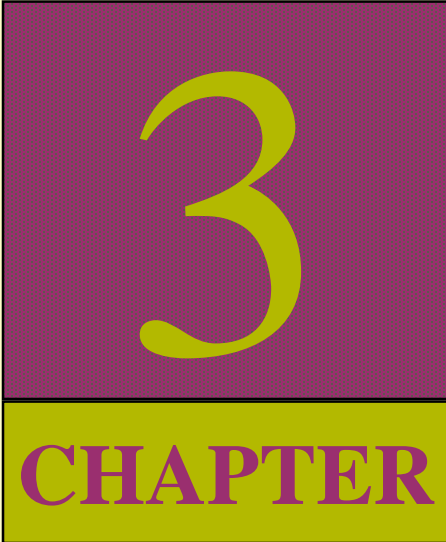


Analyzing Financing Activities



3
CHAPTER

Liabilities

Classification

Current (Short-term) Liabilities

Obligations whose settlement requires use of current assets or the incurrence of another current liability within one year or the operating cycle, whichever is longer.

Noncurrent (Long-Term) Liabilities

Obligations not payable within one year or the operating cycle, whichever is longer.

Liabilities

Alternative Classification

Operating Liabilities

Obligations that arise from operating activities--examples are accounts payable, unearned revenue, advance payments, taxes payable, postretirement liabilities, and other accruals of operating expenses

Financing Liabilities

Obligations that arise from financing activities--examples are short- and long-term debt, bonds, notes, leases, and the current portion of long-term debt

Liabilities

Important Features in Analyzing Liabilities

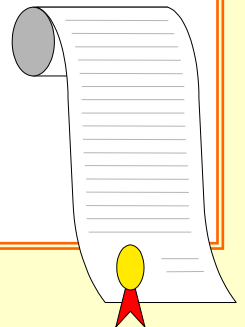
- **Terms of indebtedness** (such as maturity, interest rate, payment pattern, and amount).
- **Restrictions** on deploying resources and pursuing business activities.
- Ability and **flexibility** in pursuing further financing.
- **Obligations** for working capital, debt to equity, and other financial figures.
- **Dilutive conversion features** that liabilities are subject to.
- **Prohibitions** on disbursements such as dividends.

Leases

Leasing Facts

Lease – contractual agreement between a lessor (owner) and a lessee (user or renter) that gives the lessee the right to use an asset owned by the lessor for the lease term

MLP – minimum lease payments (MLP) of the lessee to the lessor according to the lease contract



Leases

Lease Accounting and Reporting

(1) *Capital Lease Accounting* For leases that transfer substantially all benefits and risks of ownership—accounted for as an asset acquisition and a liability incurrence by the lessee, and as a sale and financing transaction by the lessor

A lessee classifies and accounts for a lease as a capital lease if, at its inception, the lease meets *any* of four criteria:

- (i) lease transfers ownership of property to lessee by end of the lease term
- (ii) lease contains an option to purchase the property at a bargain price
- (iii) lease term is 75% or more of estimated economic life of the property
- (iv) present value of rentals and other minimum lease payments at beginning of lease term is 90% or more of the fair value of leased property less any related investment tax credit retained by lessor

(2) *Operating Lease Accounting* For leases other than capital leases—the lessee (lessor) accounts for the minimum lease payment as a rental expense (income)

Leases

Lease Disclosure and Off-Balance-Sheet Financing

Lease Disclosure

Lessee must disclose: (1) future MLPs separately for capital leases and operating leases — for each of five succeeding years and the total amount thereafter, and (2) rental expense for each period an income statement is reported

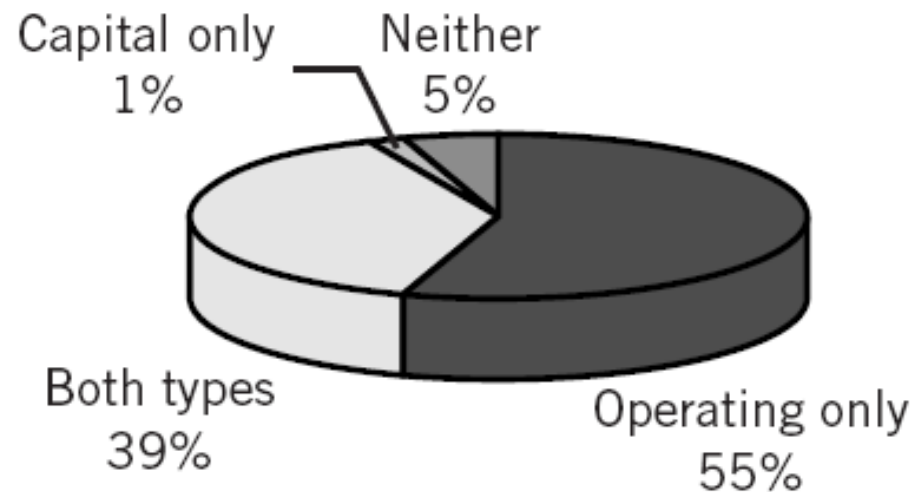
Off-Balance-Sheet Financing

Off-Balance-Sheet financing is when a lessee structures a lease so it is accounted for as an operating lease when the economic characteristics of the lease are more in line with a capital lease—neither the leased asset nor its corresponding liability are recorded on the balance sheet

Leases

Frequency of Capital and Operating Leases

Frequencies of Different Lease Types—Lessee



Leases

Accounting for Leases – An Illustration

Lease Facts

- A company leases an asset on January 1, 2000 -- it has no other assets or liabilities
- Estimated economic life of leased asset is 5 years with no salvage value -- company will depreciate the asset on a straight-line basis over its life
- Lease has a fixed non-cancelable term of 5 years with annual MLPs of \$2,505 paid at the end of each year
- Interest rate on the lease is 8% per year



Leases

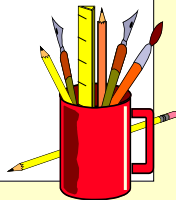
Accounting for Leases – Illustration (continued)

Lease Amortization Schedule

Year	Beg. Year Liability	Interest and Principal Components of MLP			Year-end Liability
		Interest	Principal	Total	
2000	\$10,000	\$ 800	\$ 1,705	\$ 2,505	\$8,295
2001	8,295	664	1,841	2,505	6,454
2002	6,454	517	1,988	2,505	4,466
2003	4,466	358	2,147	2,505	2,319
2004	2,319	186	2,319	2,505	0
Totals		\$2,525	\$10,000	\$12,525	

Straight-line depreciation

\$2,000 per year $([\$10,000 - \$0]/5 \text{ years})$



Leases

Accounting for Leases – Illustration (continued)

Income Statement Effects of Alternative Lease Accounting

	Operating Lease		Capital Lease				
Year	Rent Expense		Interest Expense		Depreciation Expense		Total Expense
2000	\$ 2,505		\$ 800		\$ 2,000		\$ 2,800
2001	2,505		664		2,000		2,664
2002	2,505		517		2,000		2,517
2003	2,505		358		2,000		2,358
2004	2,505		186		2,000		2,186
Total	\$ 12,525		\$ 2,525		\$ 10,000		\$ 12,525

Leases

Accounting for Leases – Illustration (continued)

Balance Sheet Effects of Capitalized Leases

Date	Cash	Leased Asset	Lease Liability	Equity
1/1/2000	0	\$ 10,000	\$ 10,000	\$ -
12/31/2000	(2,505)	8,000	8,295	(2,800)
12/31/2001	(5,010)	6,000	6,454	(5,464)
12/31/2002	(7,515)	4,000	4,466	(7,981)
12/31/2003	(10,020)	2,000	2,319	(10,339)
12/31/2004	(12,525)	0	0	(12,525)

Leases

Effects of Lease Accounting

Impact of Operating Lease When Capital Lease Is Apt:

- Operating lease understates liabilities—improves solvency ratios such as debt to equity
- Operating lease understates assets—can improve return on investment ratios
- Operating lease delays expense recognition—overstates income in early term of the lease and understates income later in lease term
- Operating lease understates current liabilities by ignoring current portion of lease principal payment—inflates current ratio & other liquidity measures
- Operating lease includes interest with lease rental (an operating expense)—understates both operating income and interest expense, inflates interest coverage ratios, understates operating cash flow, & overstates financing cash flow



Leases

Converting Operating Leases to Capital Leases

Determining the Present Value of Projected Operating Lease Payments and Lease Amortization

Determining the Present Value of Projected Operating Lease Payments and Lease Amortization (\$ millions)

Exhibit 3.6



Year	Payment	Discount Factor	Present Value	Interest	Lease Obligation	Lease Balance
2004						\$3,321
2005	\$ 454	0.94518	\$ 429	\$193	\$261	3,060
2006	424	0.89336	379	178	246	2,814
2007	391	0.84439	330	163	228	2,586
2008	385	0.79810	307	150	235	2,351
2009	379	0.75435	286	136	243	2,108
2010	379	0.71299	270	122	257	1,851
2011	379	0.67390	255	107	272	1,579
2012	379	0.63696	241	92	287	1,292
2013	379	0.60204	228	75	304	988
2014	379	0.56904	216	57	322	666
2015	379	0.53784	204	39	340	326
2016	347	0.50836	176	21	326	0
Totals	<u>\$4,654</u>		<u>\$3,321</u>			

Recasting Best Buy's Income Statement

- Operating expenses decrease by \$177 million (elimination of \$454 million rent expense reported in 2004 and addition of \$277 million of depreciation expense)
- Interest expense increases by \$193 million (to \$201 million)
- Net income decreases by \$10 million [$\16 million pretax $\times (1 - .35)$, the assumed marginal corporate tax rate] in 2004.

Recasting Best Buy's Balance Sheet

The balance sheet impact is more substantial.

- Total assets and total liabilities both increase markedly—by \$3.321 billion at the end of 2004, which is the present value of the operating lease liability.
- The increase in liabilities consists of increases in both current liabilities (\$261 million) and noncurrent liabilities (\$3.06 billion).

Leases

Restated Financial Statements after Converting Operating Leases to Capital Leases—Best Buy 2004

*Restated Balance Sheet after Converting Operating Leases to Capital Leases—
Best Buy 2004 (\$ millions)*

Exhibit 3.7



Income Statement		Before	After		
Sales		\$24,547	\$24,547		
Operating expenses		23,243	23,066		
Operating income before interest and taxes		1,304	1,481		
Interest expense (income).....		8	201		
Income taxes		496	490		
Income from continuing operations		800	790		
Discontinued operations.....		(95)	(95)		
Net income		<u>\$ 705</u>	<u>\$ 695</u>		

Balance Sheet	Before	After	Before	After	
Current assets	\$5,724	\$5,724	Current liabilities	\$4,501	\$4,762
Fixed assets.....	2,928	6,249	Long-term liabilities.....	729	3,789
			Stockholders' equity.....	3,422	3,422
Total assets	<u>\$8,652</u>	<u>\$11,973</u>	Total liabilities and equity.....	<u>\$8,652</u>	<u>\$11,973</u>

Leases

Effect of Converting Operating Leases to Capital Leases on Key Ratios-Best Buy 2004

Effect of Converting Operating Leases to Capital Leases on Key Ratios—Best Buy 2004

Exhibit 3.8



Financial Ratios	Before	After
Current ratio.....	1.27	1.20
Total debt to equity.....	1.53	2.50
Long-term debt to equity.....	0.21	1.11
Net income/Ending equity	20.6%	20.3%
Net income/Ending assets.....	8.1%	5.8%
Times interest earned.....	163.0	7.37

Postretirement Benefits

Postretirement Benefits Facts

Defined -- Employer-provided benefit(s) to employees after retirement

Two kinds of Postretirement Benefits

Pension benefits -- Employer-provided monetary pension benefits to employees after retirement, e.g., monthly stipend until death

Other Postretirement Employee Benefits (OPEB) -- Employer-provided non-pension (usually nonmonetary) benefits after retirement, e.g., health care and life insurance



Postretirement Benefits

Pension Basics

Pension Plan – agreement with employer to provide pension benefits involving 3 entities: employer-who contributes to the plan; employee-who derives benefits; and pension fund

Pension Fund Assets – account administered by a trustee, independent of employer, entrusted with responsibility of receiving contributions, investing them in a proper manner, & disbursing pension benefits to employees

Vesting – specifies employee's right to pension benefits regardless of whether employee remains with the company or not; usually conferred after employee serves some minimum period with the employer

Pension Plan Categories

Defined benefit – a plan specifying amount of pension *benefits* that employers promise to provide retirees; *employer* bears risk of pension fund performance

Defined contribution – a plan specifying amount of pension *contributions* that employers make to the pension plan; *employee* bears risk of pension fund performance

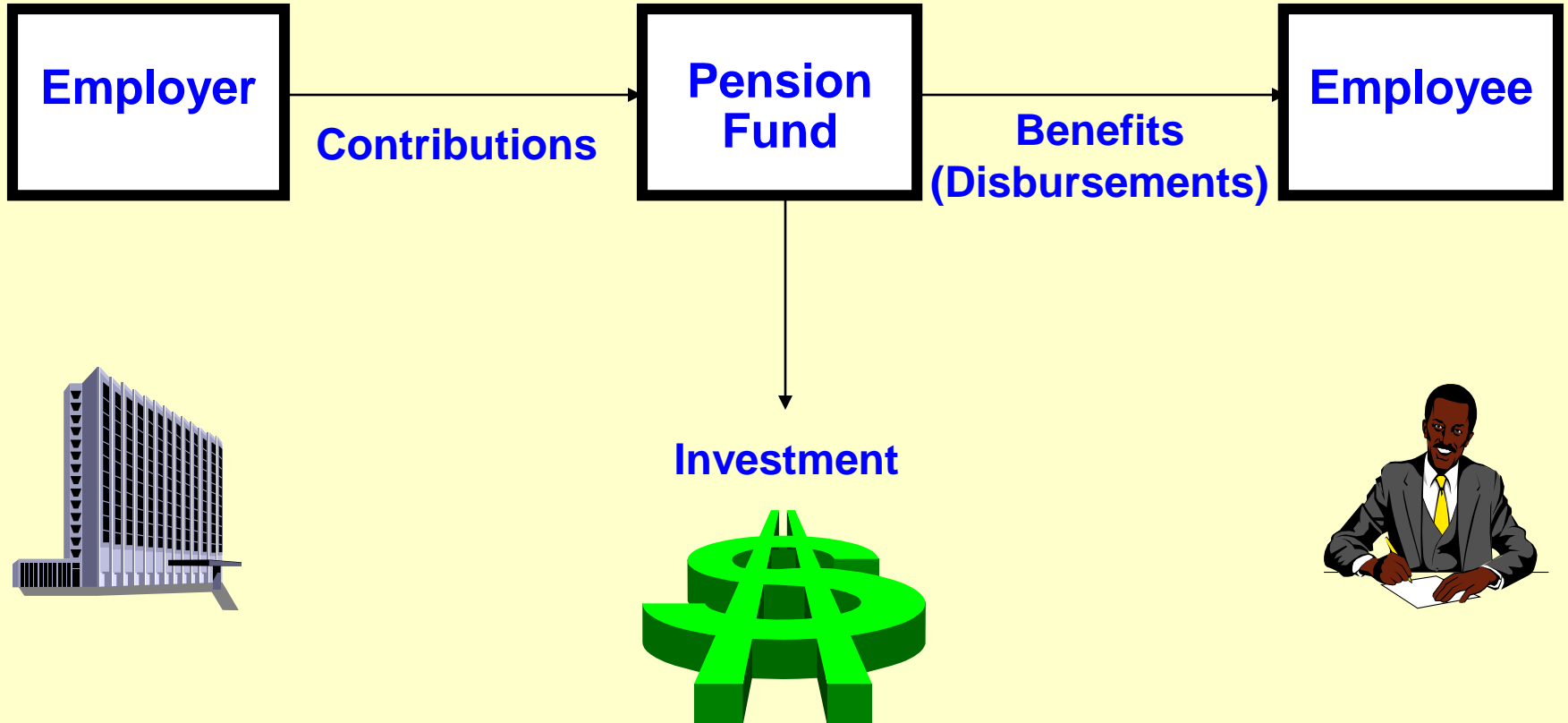
Focus of Pension Analysis

Defined benefit plans constitutes the major share of pension plans and are the focus of analysis given their implications to future company performance and financial position



Postretirement Benefits

Elements of the Pension Process



Postretirement Benefits

Illustration of Pension Accumulation and Disbursement for a Defined Benefits Plan



Annual payments into the fund required to accumulate to \$134,200 in 15 years with a discount rate of 8% per annum

Contributions = \$4,942 per annum

15 years

Preretirement

Funds required at employees' retirement:
Present value of 10 payments of \$20,000 per annum with a discount rate of 8% per annum

\$134,200

Retirement

Annual benefits of \$20,000 paid to employee for 10 years

Benefits = \$20,000 per annum

10 years

Postretirement

Postretirement Benefits

Three Alternative Definitions of Pension Obligation

Accumulated benefit obligation (ABO) – actuarial present value of pension benefits payable to employees at retirement based on their current compensation and service to-date

Project benefit obligation (PBO) – actuarial estimate of future pension benefits payable to employees on retirement based on expected future compensation and service to-date

Vested benefit obligation (VBO) – actuarial estimate of future pension benefits payable to employees at retirement based on current compensation & benefits vested to employees

Relation between Plan Assets and Funded Status

Funded Status – Difference between the value of the plan assets and the PBO

Note: Plan is *overfunded* (*underfunded*) when value of plan assets exceeds (is less than) PBO

Net Economic Position – PBO less the value of the plan assets

Postretirement Benefits

Economic Pension Cost

Economic pension cost -- net cost arising from changes in net economic position for a period; includes both *recurring* and *nonrecurring* components along with *return on plan assets*

Recurring pension costs consist of two components:

Service cost – actuarial present value of pension benefit earned by employees

Interest Cost – increase in projected benefit obligation arising when pension payments are one-period closer to being made; computed by multiplying beginning-period PBO by the discount rate

Nonrecurring pension costs consist of two components:

Actuarial Gain or Loss – change in PBO that occurs when one or more actuarial assumptions are revised in estimating PBO

Prior Service Cost – effects of changes in pension plan rules on PBO

Return on plan assets:

Actual return on plan assets – pension plan's earnings, consisting of investment income—capital appreciation and dividend and interest received, less management fees; plus realized and unrealized appreciation (or minus depreciation) of other plan assets



Postretirement Benefits

Pension Accounting Example – The Facts

- A pension plan with a single employee, J. Smith, who joins the plan exactly 5 years ago on January 1, 1996; Smith is due to retire on Dec. 31, 2020, and is expected to live for 10 years after retirement
- J. Smith's current compensation is \$10,000 per year; actuarial estimates indicate compensation is expected to increase 4% per year over the next 20 years
- Pension plan specifies the following formula for determining an employee's pension benefit: "Annual pension is equal to one week's compensation at time of retirement for each year with the plan"; employees vest 4 years after joining the plan
- At Dec. 31, 2000, the fair value of assets in the pension fund is \$2,000; in 2001, the employer contributes \$200 to the pension fund
- Return on pension assets is 22% in 2001; long-term return is expected to be 10% per year
- Discount rate is 7% per year



Postretirement Benefits

Pension Accounting Example – Pension Obligation

Determining Pension Obligations under Different Assumptions—J. Smith Example

	2000		2001		
	Actual	Formula Projected	Projected	Assumption Change Actuarial	Formula Plan
At Dec. 31, 2020 (Retirement)					
Salary per year	\$10,000	\$21,911	\$21,911	\$26,533	\$26,533
Pension per year	962	2,107	2,528	3,061	4,592
Value of pension	6,753	14,798	17,757	21,503	32,254
At Dec. 31, 2000					
Present value of pension	1,745	3,824			
At Dec. 31, 2001					
Present value of pension		4,091	4,910	5,946	8,919

Vested benefits (VBO)	\$1,745
+ Benefits not vested	0
= Accumulated benefit obligation (ABO)	\$1,745
+ Effect of estimated increase in compensation	2,079
= Projected benefit obligation (PBO)	\$3,824

Note: $PBO \geq ABO \geq VBO$

Postretirement Benefits

Pension Accounting Example – Economic Pension Cost

Recurring costs for J. Smith example:

- PBO increases by \$819 in 2001 because Smith works an extra year – hence, the term *service cost*
- Present value increases from \$3,824 in 2000 to \$4,092 in 2001—this \$267 increase arises from the time value of money – hence, the term *interest cost* (also computed as 7% x \$3,824)

Nonrecurring costs for J. Smith example:

- Actuarial change (4% to 5% growth) increases estimated compensation at retirement from \$21,911 to \$26,533 and increases the PBO at end of 2001 by \$1,036 (from \$4,910 to \$5,946) — an actuarial loss
- Pension formula changes to one-and-one-half week's compensation per year of service results in the pension benefit per year increasing by 50% from \$3,061 to \$4,592, which increases PBO by \$2,973 (\$8,919 - \$5,946) — a prior service cost

Return on plan assets for J. Smith example:

- Actual return on plan assets is \$440 (22% of \$2,000)

In sum, net economic pension cost for the J. Smith example is:

<u>Recurring costs:</u>	
Service cost	\$ 819
Interest cost	267
<u>Nonrecurring costs:</u>	
Actuarial gain or loss	1,036
Prior service cost	2,973
Gross economic pension cost	\$ 5,095
Less return on plan assets	(440)
Net economic pension cost	\$ 4,655

Postretirement Benefits

Pension Accounting Example – Articulation of Net Economic Position and Economic Pension Cost: J. Smith Example

Pension Asset			
Beginning balance	2,000		
Contributions	200		
Return on assets	440	Benefits paid	0
Ending balance	2,640		

Pension Obligation			
		Beginning balance	3,824
		Service cost	819
		Interest cost	267
		Actuarial gain or loss	1,036
Benefits paid	0	Prior service cost	<u>2,973</u>
			5,095
		Ending balance	8,919

Economic Pension Cost	
Recurring costs	
Service cost	819
Interest cost	267
Nonrecurring costs	
Actuarial gain or loss	1,036
Prior service cost	2,973
Gross pension cost	5,095
Less return on assets	(440)
Net pension cost	4,655

Net Economic Position (Funded Status)			
Contributions	200	Beginning balance	1,824
Return on assets	440	Gross pension cost	5,095
Ending balance	6,279		



Postretirement Benefits

Reported (or Net Periodic) Pension Cost

Reported pension cost -- defers recognition of economic effects vis-à-vis economic pension cost; each deferral (and amortization) follows:

Expected return on plan assets reduces reported pension cost -- gains and losses from the difference between expected and actual returns are deferred and amortized to reduce volatility; expected return on plan assets is computed by multiplying the expected long-term rate of return on plan assets by the market value of plan assets at the beginning of the period.

Deferral and amortization of net gains and losses arise from the delayed recognition of deviations from expectations regarding both pension obligations and pension assets—net gains and losses consist of (1) the difference between actual and expected return on plan assets and (2) actuarial gains and losses

Deferral and amortization of prior service cost is the process of delaying recognition of prior service cost effects on reported pension cost (through amortization)

Deferral and amortization of transition loss or gain arise when a plan is initially adopted—amortized over the average remaining service period of qualified employees

Net Reported Position (or Reported Status)

Net Reported Position -- is the cumulative reported pension cost net of cumulative contributions—for this reason, the liability (or asset) reported in the balance sheet is called **Accrued (or Prepaid) Pension Cost.**

Postretirement Benefits

Pension Accounting Example – Reported Pension Cost

- Expected return on plan assets — \$200 (10% of \$2,000) in the J. Smith example
- Deferral and amortization of net gains and losses — deferred net gains or losses is \$796 (\$1,036 actuarial loss less \$240 nonrecurring return), of which \$21 (1/20 of the excess of \$796 over 10% of \$3,824) is amortized in 2001 for the J. Smith example
- Deferral and amortization of prior service cost — prior service cost of \$2,973 is deferred and \$149 (1/20 x \$2,973) is amortized in the J. Smith example
- Deferral and amortization of transition loss or gain — no transition gain or loss in the J. Smith example

Economic Pension Cost versus Reported Pension Cost—J. Smith Example

<u>Economic pension cost</u>		<u>Smoothing</u>	<u>Reported pension cost*</u>	
Service cost	\$ 819	\$ —	Service cost	\$ 819
Interest cost	267	—	Interest cost	267
Actual return	(440)	(240)	Expected return	(200)
Actuarial gain or loss	1,036	<u>1,036</u>		—
Net gain or loss	—	\$ 796		—
Prior service cost	2,973	2,973		—
Amortization:		(21)	Net gain or loss	21
		<u>(149)</u>	Prior service cost	<u>149</u>
Total	\$ 4,655	\$ 3,612		\$ 1,056

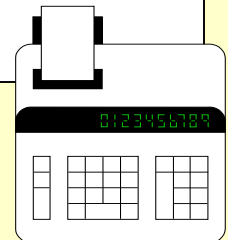
* This also is referred to as Net Periodic Pension Cost.

Postretirement Benefits

Pension Accounting Example – Net Reported Position (Reported Status)

Reported Status of Pension Fund in Balance Sheet—J. Smith Example

Projected benefit obligation	\$(8,919)
Plan assets	<u>2,640</u>
Funded status	\$(6,279)
Unrecognized transition asset	0
Unrecognized net gain or loss	775
Unrecognized prior service cost	<u>2,824</u>
Accrued pension cost (reported status)	<u>\$(2,680)</u>



Postretirement Benefits

Features of OPEB Accounting

(similar to pension accounting)

Net cost reporting – consequences of events and transactions affecting OPEB plans are reported as a single amount—this amount includes at least three components: (1) present value of the accrued cost of deferred compensation promised in exchange for employee service, (2) interest cost accruing from the passage of time until these benefits are paid, and (3) returns from the investment in the plan's assets

Delayed recognition -- certain changes in postretirement obligations, including those arising as a result of a plan initiation or amendment, and certain changes in the value of plan assets that are set aside to meet these obligations, are recognized through a process of deferral and amortization

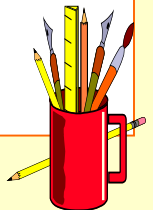
Offsetting -- plan assets restricted for payment of postretirement benefits offset the accumulated postretirement benefit obligation in determining amounts recognized in the balance sheet

Language of OPEB Accounting

Accumulated Postretirement Benefit Obligation (APBO) – employer's OPEB obligation

Expected Postretirement Benefit Obligation (EPBO) – total actuarially determined costs of providing future OPEB, recognized over the employee's expected service period

Note: APBO is the portion of EPBO "earned" by employee services as of a given date (accumulated benefits recognized to-date). Funded status of OPEB is the difference between APBO and the value of OPEB plan assets



Postretirement Benefits

Reported OPEB Cost

Reported OPEB cost includes these components:

Service costs — actuarial present value of OPEB “earned” by employees during the period; portion of EPBO attributable to the current year

Interest costs — imputed growth in APBO during the period using an assumed discount rate; interest is compounded because APBO is recognized on a present value basis

Amortization of net gains and losses — amounts arising when actual experience of the plan differs from initial estimates or, alternatively, if the expected return on assets differs from actual return; these amounts are deferred and amortized

Amortization of prior service costs — costs arising from plan amendments that change benefits and are attributed to employee service rendered prior to the amendment date; these costs are deferred and amortized

Amortization of transition obligation — costs arising from initial adoption, called *transition obligation*, are identified and measured as the difference between APBO and plan assets (if any) minus any postretirement liabilities previously recorded; either immediately recognize the transition obligation with a charge to income or amortize it

Expected return on plan assets — this return reduces the net annual postretirement expense if the plan is funded; the difference between actual and expected return is deferred and included in the unrecognized portion of net gains and losses



Postretirement Benefits

Pension and Other Postretirement Benefits Disclosures- 3M

(Millions)	QUALIFIED AND NONQUALIFIED PENSION BENEFITS				POSTRETIREMENT BENEFITS	
	UNITED STATES		INTERNATIONAL		2004	2003
	2004	2003	2004	2003		
Reconciliation of Projected Benefit Obligation						
Beginning balance.....	\$8,270	\$ 7,221	\$3,350	\$2,872	\$1,712	\$1,453
Service cost.....	164	148	101	100	52	47
Interest cost.....	483	474	166	145	100	96
Participant contributions.....	—	—	10	9	34	22
Foreign exchange rate changes.....	—	—	273	404	5	7
Plan amendments.....	3	5	(16)	(91)	—	(102)
Actuarial (gain) loss.....	618	889	187	6	74	329
Benefit payments.....	(613)	(491)	(118)	(96)	(185)	(140)
Settlements, curtailments, special termination benefits.....	24	24	(57)	1	—	—
Ending balance.....	\$8,949	\$ 8,270	\$3,896	\$3,350	\$1,792	\$1,712

Postretirement Benefits

Pension and Other Postretirement Benefits Disclosures- 3M

(Millions)	QUALIFIED AND NONQUALIFIED PENSION BENEFITS				POSTRETIREMENT BENEFITS	
	UNITED STATES		INTERNATIONAL		2004	2003
	2004	2003	2004	2003		
Reconciliation of Plan Assets at Fair Value						
Beginning balance	\$7,094	\$5,913	\$2,731	\$2,070	\$ 877	\$ 626
Actual return on plan assets	1,616	1,050	230	283	209	159
Company contributions	325	622	271	127	198	210
Participant contributions	—	—	11	9	34	22
Foreign exchange rate changes	—	—	237	337	—	—
Benefit payments	(613)	(491)	(118)	(96)	(185)	(140)
Settlements, curtailments, special termination benefits	—	—	(57)	1	—	—
Ending balance	\$8,422	\$ 7,094	\$3,305	\$2,731	\$1,133	\$ 877

Postretirement Benefits

Pension and Other Postretirement Benefits Disclosures- 3M

(Millions)	QUALIFIED AND NONQUALIFIED PENSION BENEFITS				POSTRETIREMENT BENEFITS	
	UNITED STATES		INTERNATIONAL		2004	2003
	2004	2003	2004	2003		
Funded Status of Plans						
Plan assets at fair value less than benefit obligation.....	\$ (527)	\$(1,176)	\$ (591)	\$ (619)	\$ (659)	\$ (835)
Unrecognized transition (asset) obligation	—	—	11	6	—	—
Unrecognized prior service cost (benefit)	89	100	(83)	(69)	(193)	(233)
Unrecognized net actuarial (gain) loss	2,121	2,648	1,023	857	919	1,051
Adjustment for fourth quarter	—	(1)	—	—	—	30
Net amount recognized.....	\$1,683	\$1,571	\$ 360	\$ 175	\$ 67	\$ 13

Weighted Average Assumptions Used to Determine Net Cost for Years Ended

Discount rate.....	6.00%	6.75%	4.95%	4.78%	6.00%	6.75%
Expected return on assets.....	9.00%	9.00%	7.09%	7.27%	9.39%	9.42%
Compensation rate increase	4.30%	4.60%	3.46%	3.58%	4.30%	4.60%

Postretirement Benefits

Pension and Other Postretirement Benefits Disclosures- 3M

(Millions)	QUALIFIED AND NONQUALIFIED PENSION BENEFITS				POSTRETIREMENT BENEFITS	
	UNITED STATES		INTERNATIONAL		2004	2003
	2004	2003	2004	2003		
Components of net periodic benefit cost and other supplemental information for the year ended December 31 follow:						
Benefit Plan Information						
Service cost	\$ 164	\$ 148	\$ 101	\$ 100	\$ 52	\$47
Interest cost.....	483	474	166	145	100	96
Expected return on plan assets.....	(627)	(621)	(202)	(179)	(87)	(78)
Amortization of transition (asset) obligation	—	—	5	3	—	—
Amortization of prior service cost (benefit)	14	14	(2)	2	(39)	(32)
Recognized net actuarial (gain) loss	159	30	43	28	84	55
Net periodic benefit cost	\$ 193	\$ 45	\$ 111	\$ 99	\$ 110	\$ 88
Settlements, curtailments, and special termination benefits.....	21	24	—	—	—	—
Net periodic benefit cost after settlements, curtailments, and special termination benefits.....	\$ 214	\$ 69	\$ 111	\$ 99	\$ 110	\$ 88

Economic vs. Reported Cost

3M

Economic and Reported Postretirement Costs—3M

Exhibit 3.14



	TOTAL			U.S. PLANS			INTERNATIONAL PLANS		
	Economic	Deferred (net)	Reported	Economic	Deferred (net)	Reported	Economic	Deferred (net)	Reported
Pension Expense									
Service cost	\$ 265	—	\$ 265	\$ 164	—	\$ 164	\$ 101	—	\$ 101
Interest cost.....	649	—	649	483	—	483	166	—	166
Losses (gains) in investments.....	(1,846)	\$ 1,017	(829)	(1,616)	\$ 989	(627)	(230)	\$ 28	(202)
Actuarial losses (gains)	805	(603)	202	618	(459)	159	187	(144)	43
Other.....	47	(9)	38	27	8	35	20	(17)	3
Total	<u>\$ (80)</u>	<u>\$ 405</u>	<u>\$ 325</u>	<u>\$ (324)</u>	<u>\$ 538</u>	<u>\$ 214</u>	<u>\$ 244</u>	<u>\$ (133)</u>	<u>\$ 111</u>
OPEB									
Service cost	\$ 52	—	\$ 52						
Interest cost.....	100	—	100						
Losses (gains) in investments	(209)	\$ 122	(87)						
Actuarial losses (gains)	74	10	84						
Other.....	5	(44)	(39)						
Total	<u>\$ 22</u>	<u>\$ 88</u>	<u>\$ 110</u>						
Total									
Service cost	\$ 317	—	\$ 317						
Interest cost.....	749	—	749						
Losses (gains) in investments	(2,055)	\$ 1,139	(916)						
Actuarial losses (gains)	879	(593)	286						
Other.....	52	(53)	(1)						
Total.....	<u>\$ (58)</u>	<u>\$ 493</u>	<u>\$ 435</u>						

Postretirement Benefits

Reconciliation of Economic and Reported Changes- 3M

Exhibit 3.15

Economic and Reported Postretirement Benefits—3M



	PENSION			Total
	U.S.	International	OPEB	
Benefit obligations	\$8,949	\$3,896	\$1,792	\$14,637
Plan assets.....	8,422	3,305	1,133	12,860
Funded status	(527)	(591)	(659)	(1,777)
Unrecognized net loss.....	2,121	1,023	919	4,063
Unrecognized prior service cost	89	(83)	(193)	(187)
Unrecognized transition assets		11	0	11
Net asset (liability) recognized	\$1,683	\$ 360	\$ 67	\$ 2,110



	Reported	Economic	Difference
Income Statement			
Sales.....	\$20,011	\$20,011	\$ 0
Operating expenses.....	15,433	14,940	(493)
Operating income.....	4,578	5,071	493
Interest	23	23	0
Income before taxes	4,555	5,048	493
Income taxes.....	1,565	1,734	169
Net income.....	<u>\$ 2,990</u>	<u>\$ 3,314</u>	324
Balance Sheet			
Assets			
Current.....	\$ 8,720	\$8,720	
Noncurrent	11,988	11,988	
Total assets.....	<u>\$20,708</u>	<u>\$20,708</u>	
Liabilities and Equity			
Current.....	\$ 6,071	\$6,071	
Noncurrent	4,259	8,146	3,887
Stockholders' equity.....	10,378	6,491	(3,887)
Total liability and equity.....	<u>\$20,708</u>	<u>\$20,708</u>	
Ratios			
Total debt to equity	1.00	2.19	
Long-term debt to equity.....	0.41	1.25	
Return on assets.....	14.4%	16.2%	
Return on common equity	28.8%	51.6%	

Postretirement Benefits

Effect of Actuarial Assumptions on Benefit Obligation and Cost

Assumption	Direction of Change	Direction of Effect on			
		Economic*		Reported*	
		Position	Cost	Position	Cost
Discount Rate	+ -	+ -	- +	Indefinite Indefinite	Indefinite Indefinite
Expected Return	+ -	No effect No effect	No effect No effect	+ -	- +
Growth Rate**	+ -	- +	+ -	- +	+ -

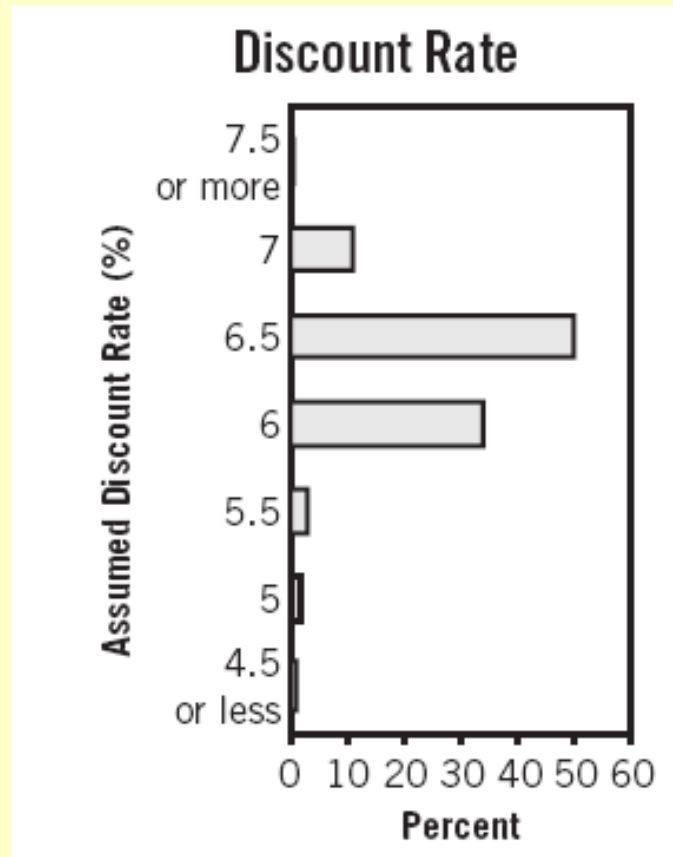
Notes: * Economic position refers to funded status and reported position refers to accrued benefit or cost.

** Growth rate pertains to both compensation and health care costs.



Postretirement Benefits

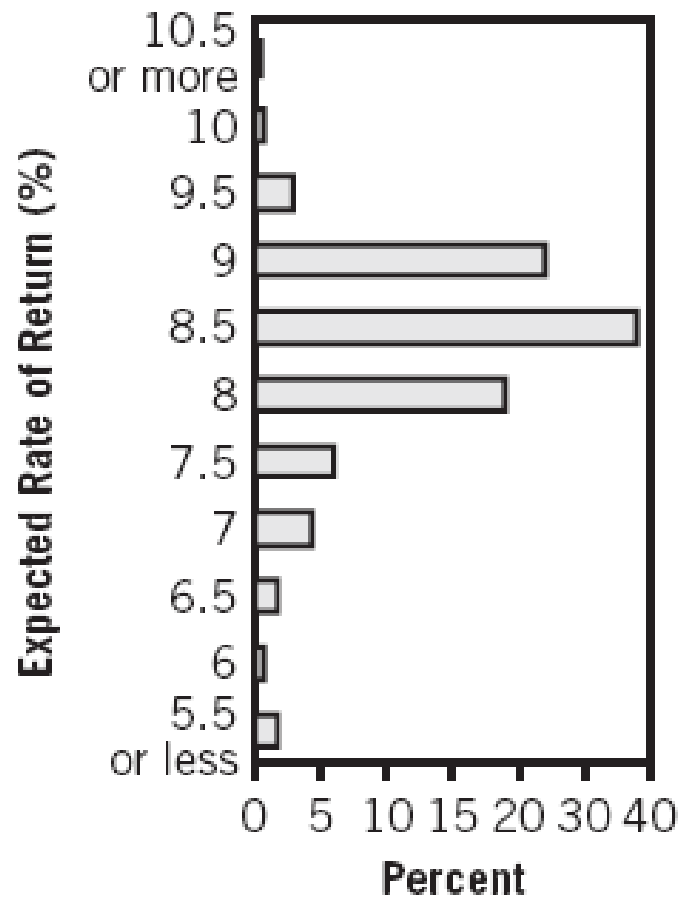
Frequency Distribution of Actuarial Assumptions



Postretirement Benefits

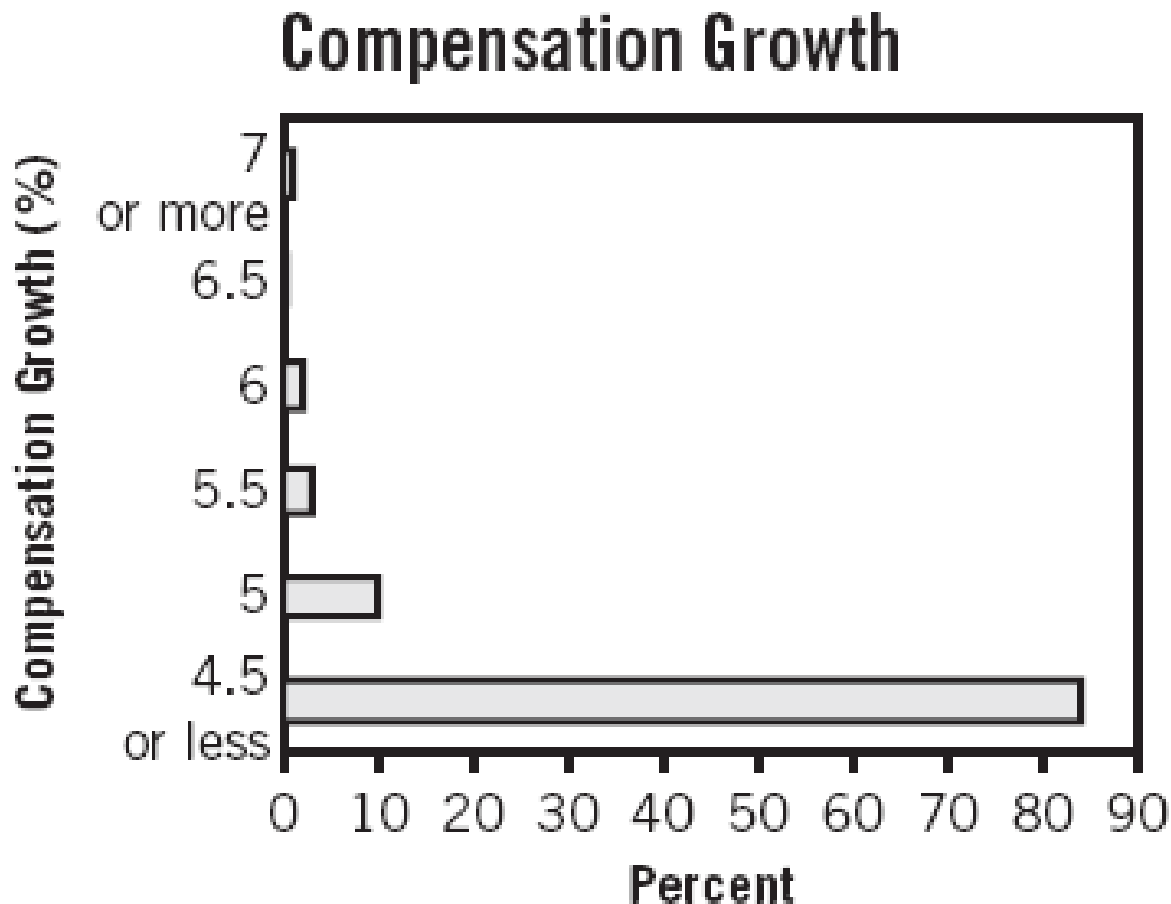
Frequency Distribution of Actuarial Assumptions

Expected Rate of Return



Postretirement Benefits

Frequency Distribution of Actuarial Assumptions



Contingencies and Commitments

Basics of Contingencies

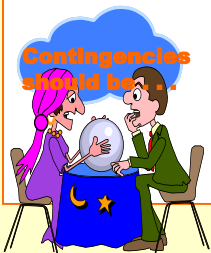
Contingencies -- potential losses and gains whose resolution depends on one or more future events.

Contingent liabilities -- contingencies with potential claims on resources

- to record a contingent liability (and loss) two conditions must be met:
 - (i) *probable* an asset is impaired or a liability incurred, and
 - (ii) the amount of loss is *reasonably estimable*;
- to disclose a contingent liability (and loss) there must be at least a *reasonable possibility* of incurrence

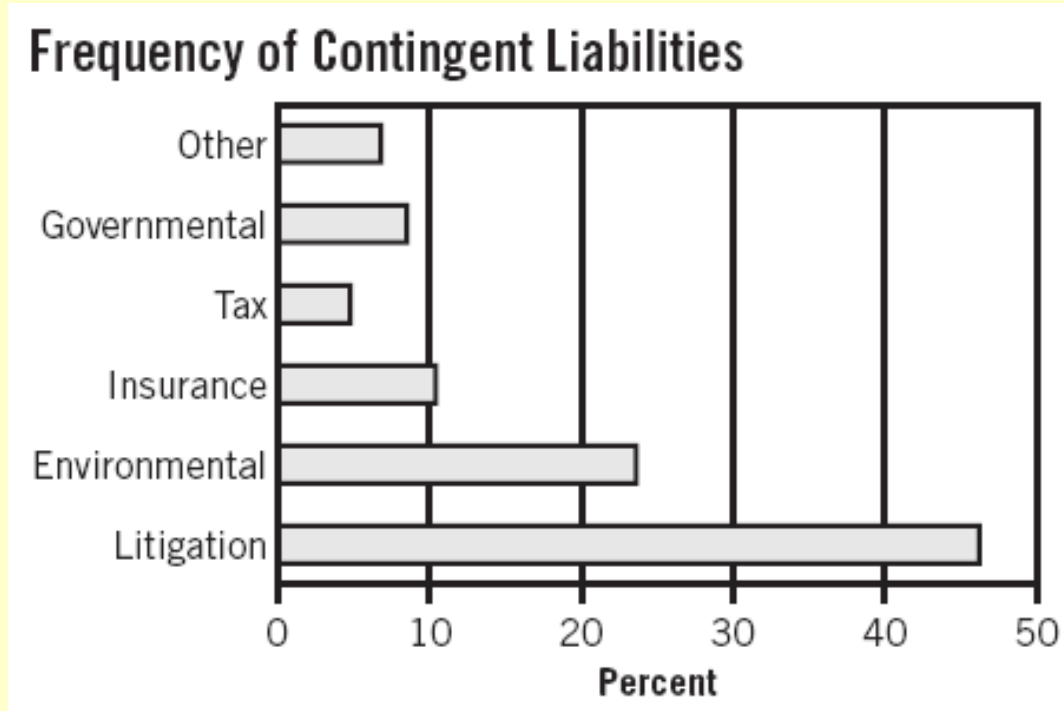
Contingent assets

- contingencies with potential additions to resources
- a contingent asset (and gain) is not recorded until the contingency is resolved
- a contingent asset (and gain) can be disclosed if probability of realization is high



Contingencies and Commitments

Frequency of Contingent Liabilities



Contingencies and Commitments

Analyzing Contingencies

Sources of useful information:

Notes, MD&A, and Deferred Tax Disclosures

Useful analyses:

- Scrutinize management estimates
- Analyze notes regarding contingencies, including
 - Description of contingency and its degree of risk
 - Amount at risk and how treated in assessing risk exposure
 - Charges, if any, against income
- Recognize a bias to not record or underestimate contingent liabilities
- Beware of *big baths* — loss reserves are contingencies
- Review SEC filings for details of loss reserves
- Analyze deferred tax notes for undisclosed provisions for future losses

Note: Loss reserves do not alter risk exposure, have no cash flow consequences, and do not provide insurance

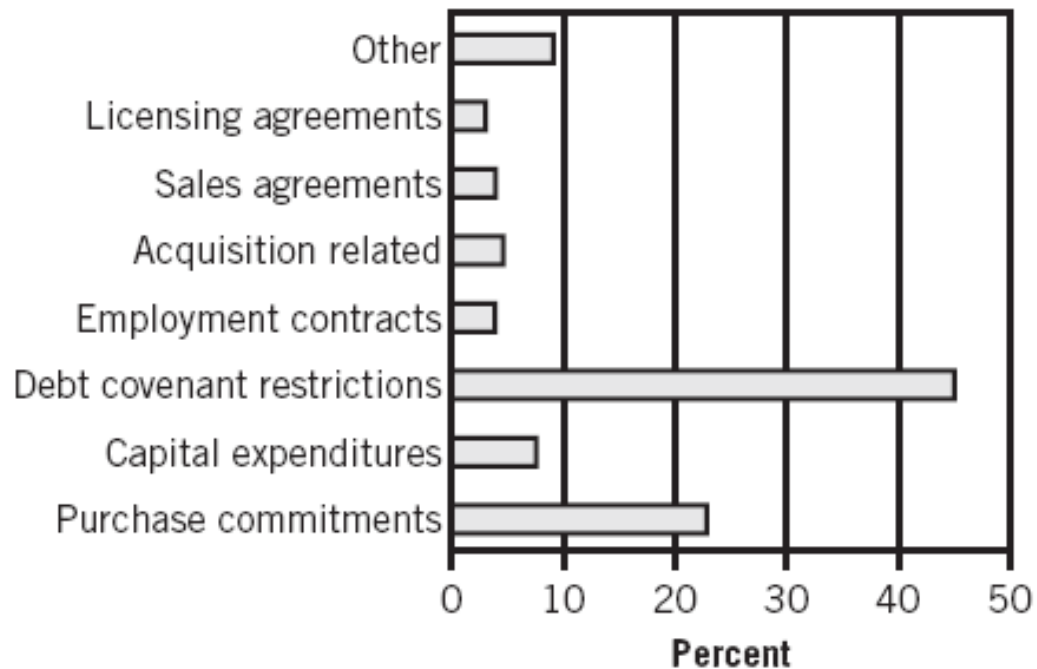


Contingencies and Commitments

Basics of Commitments

Commitments -- potential claims against a company's resources due to future performance under contract

Frequency of Commitments



Off-Balance-Sheet Financing

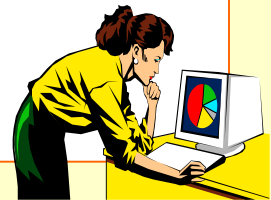
Analyzing Commitments

Sources of useful information:

Notes and MD&A and SEC Filings

Useful analyses:

- Scrutinize management communications and press releases
- Analyze notes regarding commitments, including
 - Description of commitment and its degree of risk
 - Amount at risk and how treated in assessing risk exposure
 - Contractual conditions and timing
- Recognize a bias to not disclose commitments
- Review SEC filings for details of commitments



Off-Balance-Sheet Financing

Basics of Off-Balance-Sheet Financing

Off-Balance-Sheet Financing -- is the non-recording of financing obligations

Motivation

To keep debt off the balance sheet—part of ever-changing landscape, where as one standard tries to better reflect obligations from a certain off-balance-sheet financing transaction, there are new and innovative means to take its place

Transactions sometimes used as off-balance-sheet financing:

- Operating leases that are indistinguishable from capital leases
- Through-put agreements, where a company agrees to run goods through a processing facility
- Take-or-pay arrangements, where a company guarantees to pay for goods whether needed or not
- Certain joint ventures and limited partnerships
- Product financing arrangements, where a company sells and agrees to either repurchase inventory or guarantee a selling price
- Sell receivables with recourse and record them as sales rather than liabilities
- Sell receivables as backing for debt sold to the public
- Outstanding loan commitments



Off-Balance-Sheet Financing

Analysis of Off-Balance-Sheet Financing

Sources of useful information:

Notes and MD&A and SEC Filings

Companies disclose the following info about financial instruments with off-balance-sheet risk of loss:

- Face, contract, or principal amount
- Terms of the instrument and info on its credit and market risk, cash requirements, and accounting Loss incurred if a party to the contract fails to perform
- Collateral or other security, if any, for the amount at risk
- Info about concentrations of credit risk from a counterparty or groups of counterparties

Useful analyses:

- Scrutinize management communications and press releases
- Analyze notes about financing arrangements
- Recognize a bias to not disclose financing obligations
- Review SEC filings for details of financing arrangements



Off-Balance-Sheet Financing

Illustration of SPE Transaction to Sell Accounts Receivable

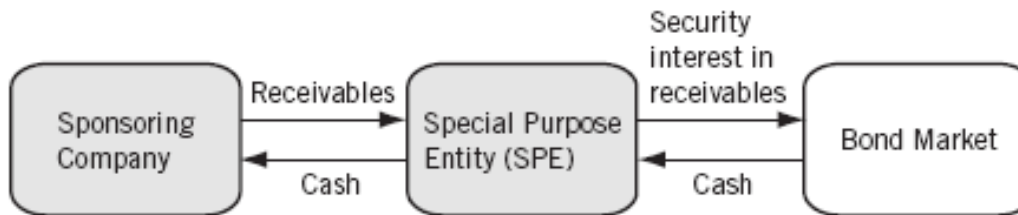
- A special purpose entity is formed by the sponsoring company and is capitalized with equity investment, some of which must be from independent third parties.
- The SPE leverages this equity investment with borrowings from the credit markets and purchases earning assets from or for the sponsoring company.
- The cash flow from the earning assets is used to repay the debt and provide a return to the equity investors.

Off-Balance-Sheet Financing

Illustration of SPE Transaction to Sell Accounts Receivable

Illustration of SPE Transaction to Sell Accounts Receivable

Exhibit 3.18



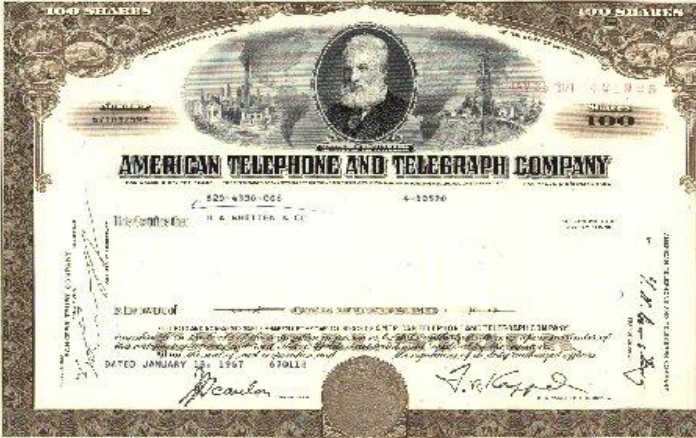
Off-Balance-Sheet Financing

Benefits of SPEs:

- 1. SPEs may provide a lower-cost financing alternative than borrowing from the credit markets directly.**
- 2. Under present GAAP, so long as the SPE is properly structured, the SPE is accounted for as a separate entity, unconsolidated with the sponsoring company.**

Shareholders' Equity

Basics of Equity Financing



Equity — refers to owner (shareholder)

financing; its usual characteristics include:

- Reflects claims of owners (shareholders) on net assets
- Equity holders usually subordinate to creditors
- Variation across equity holders on seniority
- Exposed to maximum risk and return

Equity Analysis — involves analyzing equity characteristics, including:

- Classifying and distinguishing different equity sources
- Examining rights for equity classes and priorities in liquidation
- Evaluating legal restrictions for equity distribution
- Reviewing restrictions on retained earnings distribution
- Assessing terms and provisions of potential equity issuances

Equity Classes — two basic components:

- Capital Stock
- Retained Earnings

Shareholders' Equity

Reporting Capital Stock

Sources of increases in capital stock outstanding:

- Issuances of stock
- Conversion of debentures and preferred stock
- Issuances pursuant to stock dividends and splits
- Issuances of stock in acquisitions and mergers
- Issuances pursuant to stock options and warrants exercised

Sources of decreases in capital stock outstanding:

- Purchases and retirements of stock
- Purchases of treasury stock
- Reverse stock splits



Shareholders' Equity

Components of Capital Stock

Contributed (or Paid-In) Capital — total financing received from shareholders for capital shares; usually consists of two parts:

- **Common (or Preferred) Stock** — financing equal to par or stated value; if stock is no-par, then equal to total financing
- **Contributed (or Paid-In) Capital in Excess of Par or Stated Value** — financing in excess of any par or stated value



Shareholders' Equity

Two Types of Capital Stock

Preferred Stock — capital stock with features not possessed by common stock; typical preferred stock features include:

- Dividend distribution preferences
- Liquidation priorities
- Convertibility (redemption) into common stock
- Call provisions
- Sinking fund provisions

Common Stock — capital stock with ownership interest and bearing ultimate risks and rewards (residual interests)



Shareholders' Equity

Basics of Retained Earnings

Retained Earnings — earned capital of a company; reflects accumulation of undistributed earnings or losses since inception; retained earnings is the main source of dividend distributions

Cash and Stock Dividends

- Cash dividend — distribution of cash (or assets) to shareholders
- Stock dividend — distribution of capital stock to shareholders

Prior Period Adjustments — mainly error corrections of prior periods' statements

Appropriations of Retained Earnings — reclassifications of retained earnings for specific purposes

Restrictions (or Covenants) on Retained Earnings — constraints or requirements on retention of retained earnings



Shareholders' Equity

Shareholder's Equity Section of Kimberly Corp. for periods ending in Year 4 and 5

	Year 5	Year 4
Preferred stock, 7% cumulative, par value \$100 (authorized 4,000,000; outstanding 3,602,811)	\$ 360,281,100	\$ 360,281,100
Common Stock, par value \$16.67 (authorized 90,000,000 shares; outstanding 54,138,137 shares at December 31, Year 5 and 54,129,987 shares at December 31, Year 4)	902,302,283	902,166,450
Retained earnings	2,362,279,244	902,166,450
Total shareholder's equity	\$3,624,862,627	\$ 2,220,298,288

*Note: Preferred stock is nonparticipating and callable at 105. Dividends for Year 5 are in arrears

Shareholders' Equity

Calculated Book Value per Share

	Preferred		Common	Total
Preferred stock* (at \$100 par)	\$ 360,281,100			\$ 360,281,100
Dividends in arrears (7%)	25,219,677			25,219,677
Common stock			\$ 902,302,283	902,302,283
Retained earnings (net of amount attributed to dividend in arrears)			2,337,059,567	2,337,059,567
Total	\$ 385,500,777		\$ 3,239,361,850	\$ 3,624,862,627
Divided by number of shares outstanding	3,602,811		54,138,137	
Book value per share	\$ 107.00		\$ 59.84	

*The call premium does not normally enter into computation of book value per share because the call provision is at the option of the company

Spin-offs and Split-offs

- **Spin-off**, the distribution of subsidiary stock to shareholders as a dividend; assets (investment in subsidiary) are reduced as is retained earnings.
- **Split-off**, the exchange of subsidiary stock owned by the company for shares in the company owned by the shareholders; assets (investment in subsidiary) are reduced and the stock received from the shareholders is treated as treasury stock.