Appendix C

Comprehensive Case

Learning Objectives

LO1 Explain and illustrate a review of financial statements and their components. (p. C-4)

LO2 Assess company profitability and creditworthiness. (p. C-27)

LO3 Forecast financial statements. (p. C-29)

LO4 Describe and illustrate the valuation of firm equity. (p. C-32)

Kimberly-Clark

The past decade has seen a shift in the competitive landscape for consumer products companies. Gone are numerous competitors. Many were gobbled up in the industry's consolidation trend. Also gone is media control. Now, hundreds of different media outlets and venues compete for promotion space and scarce consumer time.

Another development is in-store branding. Companies such as **Costco**, with its Kirkland Signature brand on everything from candy to apparel, threaten the powerhouse brands from **Kimberly-Clark**, **Procter & Gamble**, **Colgate-Palmolive**, and other consumer products companies.

Ten years ago, when Thomas J. Falk assumed the top spot at Kimberly-Clark, the nation's largest disposable diaper producer, he inherited some extra baggage: a company in the throes of an identity crisis, a decades-long rivalry with consumer-products behemoth Procter & Gamble, and a group of investors short on patience following a series of earnings misses.

In a move aimed at boosting its stock price and its return on equity, Kimberly-Clark spun off its paper and pulp businesses in 2004, and began a strategic investment and streamlining initiative in 2005. Under Falk's leadership, the company has steadily improved its focus on its health and hygiene segments.

Kimberly-Clark has also moved to shore up its brand images across its immense product line. With sales of more than $21 billion, the company manufactures such well-recognized brands as Huggies and Pull-Ups disposable diapers, Kleenex facial tissue, Viva paper towels, and Scott bathroom tissue.

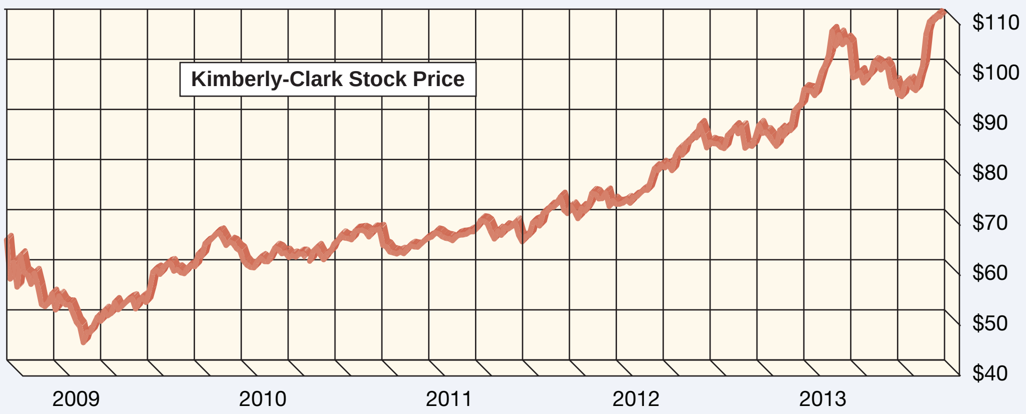
Despite formidable competitors like Procter & Gamble, Kimberly-Clark's financial performance has been steady, as

Courtesy of Getty Images

has been its stock price rise over the past five years (see the stock price chart below). Moreover, Kimberly-Clark's earnings performance is consistent, and its financial position is solid. Kimberly-Clark's RNOA for 2012 was 18.0%, and its nonoperating return increased RNOA to yield a robust 34.2% in return on equity. It also reported $19.9 billion in assets, 41% of which is concentrated in plant, property, and equipment, and another 18% in intangible assets.

This module presents a financial accounting analysis and interpretation of Kimberly-Clark. It is intended to illustrate the key financial reporting topics covered in the book. We begin with a detailed review of Kimberly-Clark's financial statements and notes, followed by the forecasting of key accounts that we use to value its common stock.

Source: *Kimberly-Clark* 2012 10-K Filings and Annual Report to Shareholders.



APPENDIX ORGANIZATION

Comprehensive Case

Reviewing the Financial Statements
- Income Statement
- Balance Sheet
- Off-Balance-Sheet
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Assessing Profitability and Creditworthiness
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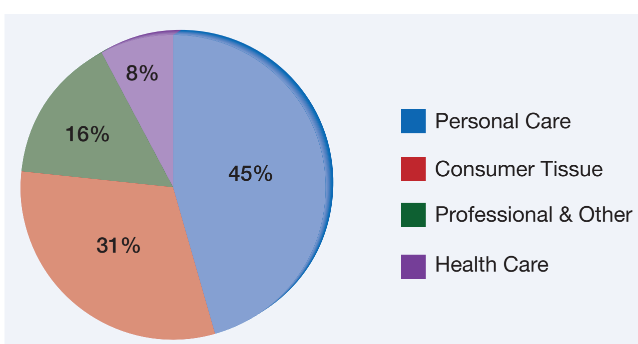
INTRODUCTION

Kimberly-Clark is one of the largest consumer products companies in the world. It is organized into four general business segments (percentages are for 2012):

- **Personal Care** (45% of sales), which manufactures and markets disposable diapers, training and youth pants, swim pants, baby wipes, feminine and incontinence care products, and related products. Products in this segment are primarily for household use and are sold under a variety of brand names, including Huggies, Pull-Ups, Little Swimmers, GoodNites, Kotex, Depend, Poise and other brand names.
- **Consumer Tissue** (31% of sales), which manufactures and markets facial and bathroom tissue, paper towels, napkins and related products for household use. Products in this segment are sold under the Kleenex, Scott, Cottonelle, Viva, Andrex, Scottex, Hakle, Page and other brand names.
- **Professional & Other** (16% of sales), which manufactures and markets facial and bathroom tissue, paper towels, napkins, wipes and a range of safety products for the away-from-home marketplace. Products in this segment are sold under the Kleenex, Scott, WypAll, Kimtech and Jackson Safety brand names.
- **Health Care** (8% of sales), which manufactures and markets health care products such as surgical drapes and gowns, infection control products, face masks, exam gloves, respiratory products, pain management products and other disposable medical products. Products in this segment are sold under the Kimberly-Clark, ON-Q and other brand names.



Approximately 49% of Kimberly-Clark's sales are in North America, 15% in Europe and 36% in Asia, Latin America, and other areas. In addition, approximately 12% of Kimberly-Clark's sales are made to **Walmart**, primarily in the personal care and consumer tissue businesses (source: Kimberly-Clark 2012 10-K).

In the MD&A section of its 10-K, Kimberly-Clark describes its competitive environment as follows:

> We compete in highly competitive markets against well-known, branded products and low-cost or private label products both domestically and internationally. Inherent risks in our competitive strategy include uncertainties concerning trade and consumer acceptance, the effects of consolidation within retailer and distribution channels, and competitive actions. Our competitors for these markets include not only our traditional competitors but also private label manufacturers, low-cost manufacturers and rapidly expanding international manufacturers. Some of these competitors may have better access to financial resources and greater market penetration, which enable them to offer a wider variety of products and services at more competitive prices. Alternatively, some of these competitors may have significantly lower product development and manufacturing costs, allowing them to offer products at a lower price. The actions of these competitors could adversely affect our financial results. It may be necessary for us to lower prices on our products and increase spending on advertising and promotions, each of which could adversely affect our financial results. In addition, we compete in highly competitive regional markets, such as Latin America, Europe, Africa and Asia. Intense competition in these areas may slow our sales growth and earnings potential, as well as adversely impact our margins.
>
> Our ability to develop new products is affected by whether we can successfully anticipate consumer needs and preferences, develop and fund technological innovations, and receive and maintain necessary patent and trademark protection. In addition, we incur substantial development and marketing costs in introducing new and improved products and technologies. The introduction of a new consumer product (whether improved or newly developed) usually requires substantial expenditures for advertising and marketing to gain recognition in the marketplace. If a product gains consumer acceptance, it normally requires continued advertising and promotional support to maintain its relative market position. Some of our competitors may spend more aggressively on advertising and promotional activities, introduce competing products more quickly and respond more effectively to changing business and economic conditions.

Beyond the competitive business risks described above, Kimberly-Clark faces fluctuating prices for cellulose fiber, the company's principle raw material, uncertain energy costs for manufacturing operations, foreign currency translation risks, and risks resulting from fluctuating interest rates.

Given this background, we begin the accounting analysis of Kimberly-Clark with a discussion of its financial statements.

REVIEWING THE FINANCIAL STATEMENTS

This section reviews and analyzes the financial statements of Kimberly-Clark.

LO1 Explain and illustrate a review of financial statements and their components.

Income Statement Reporting and Analysis

Kimberly-Clark's income statement is reproduced in Exhibit C.1. The remainder of this section provides a brief review and analysis for Kimberly-Clark's income statement line items.

EXHIBIT C.1 Kimberly-Clark Income Statement

KIMBERLY-CLARK CORPORATION AND SUBSIDIARIES
Consolidated Income Statement

Year Ended December 31 (Millions of dollars, except per share amounts)	2012	2011	2010
Net sales	**$21,063**	$20,846	$19,746
Cost of products sold	**14,314**	14,694	13,196
Gross profit	**6,749**	6,152	6,550
Marketing, research and general expenses	**4,069**	3,761	3,673
Other (income) and expense, net	**(6)**	(51)	104
Operating profit	**2,686**	2,442	2,773
Interest income	**18**	18	20
Interest expense	**(284)**	(277)	(243)
Income before income taxes and equity interests	**2,420**	2,183	2,550
Provision for income taxes	**(768)**	(660)	(788)
Income before equity interests	**1,652**	1,523	1,762
Share of net income of equity companies	**176**	161	181
Net income	**1,828**	1,684	1,943
Net income attributable to noncontrolling interests	**(78)**	(93)	(100)
Net income attributable to Kimberly-Clark Corporation	**$ 1,750**	$ 1,591	$ 1,843
Per share basis			
Net income attributable to Kimberly-Clark Corporation			
Basic	**$ 4.45**	$ 4.02	$ 4.47
Diluted	**$ 4.42**	$ 3.99	$ 4.45

Net Sales

Exhibit C.1 reveals that sales increased 1.04% in 2012 to $21,063 million, following a 5.57% sales increase in the prior year. In its 2012 MD&A report, management attributes the increase equally to volume, price and mix effects.

Kimberly-Clark describes its revenue recognition policy as follows:

> Sales revenue is recognized at the time of product shipment or delivery, depending on when title passes, to unaffiliated customers, and when all of the following have occurred: a firm sales agreement is in place, pricing is fixed or determinable, and collection is reasonably assured. Sales are reported net of returns, consumer and trade promotions, rebates and freight allowed. Taxes imposed by governmental authorities on our revenue-producing activities with customers, such as sales taxes and value-added taxes, are excluded from net sales.

Its revenue recognition conditions are taken directly from GAAP and SEC guidelines, which recognize revenues when "earned and realizable." For Kimberly-Clark, *earned* means when title to the goods passes to the customer, and *realizable* means an account receivable whose collection is reasonably assured.

Sales for retailers and manufacturers are straightforward: revenue is recognized when the product is transferred to the buyer, an obligation for payment exists and collection of that payment is reasonably assured. In that case, the revenue is deemed to have been "earned." The primary issue for retailers and manufacturers relates to sales return allowances. These allowances pertain to product return or sales discounts (sometimes called *mark-downs*). Companies can only report sales when earned, that is, past the return allowance period. Further, companies can only report *net* sales as revenue (i.e., gross sales less any sales discounts, including volume discounts). K-C's footnotes provide the following table relating to sales allowances:

December 31, 2012 ($ millions)	Balance at Beginning of Period	Additions: Charged to Costs and Expenses	Additions: Charged to Other Accounts	Deductions: Write-Offs and Reclassifications	Balance at End of Period
Allowances for sales discounts	$21	$280	—	$281	$20

K-C's balance sheet includes a contra-asset related to sales discounts. The table indicates that the company had $21 million in sales discounts accrued at the start of the year that relate to sales in the prior year. During 2012, K-C granted its customers $280 million in additional sales discounts, $281 million of which had been taken by the customers by the end of the year. The remaining amount of $20 million, relates to discounts granted, but not yet taken, and is held over to the following year. These year-end amounts typically relate to discounts given toward the end of the year that are ultimately taken in the first quarter of the following year.

The sales discount process affects net sales and, thus, profit. This allowance works just like any other allowance. If K-C underestimated the sales discount allowance, net sales and profit in the current year would be increased. Overestimation of the sales discount allowance would have the opposite effect: current sales and profit would be depressed. K-C's allowance has not changed appreciably in 2012 and is, therefore, not of concern.

Revenue recognition in service industries and those industries that have multiple-element sales contracts can be problematic. Often, determining when a particular element of the contract has been "earned" can be difficult and revenue can easily be mis-estimated, either intentionally or not. For example, Hewlett Packard acquired Autonomy in 2011 and later claimed that serious accounting improprieties on the part of Autonomy forced HP to take an $8.8 billion charge to income. HP CEO, Meg Whitman, asserted that Autonomy accelerated revenue recognition and misconstrued lower-margin hardware sales as higher-margin software business. Prior to the deal, Autonomy's accounts were audited by HP's public accountants, who arguably missed the revenue recognition errors on the multiple-element sales at Autonomy.

Cost of Products Sold and Gross Profit

Kimberly-Clark's 2012 gross profit margin is 32% ($6,749/$21,063), which is about one percentage point less than what it was in 2010 (33.2%). As a benchmark, **Procter & Gamble**, the company's principle competitor, recently reported sales of $84.2 billion, over four times the level of K-C's sales, and a gross profit margin of 49.6%. This comparison highlights the intense competition that K-C faces from its much larger rival.

The choice of inventory costing method affects cost of goods sold. K-C uses the LIFO method to cost its inventory. In 2012, the company's LIFO reserve decreased by $49 million (see inventory discussion later in this Appendix). This decreased cost of goods sold and improved gross profit by $49 million.

Marketing, Research and General Expenses

Kimberly-Clark's marketing, research and general expenses have increased to 19.3% of sales from 18.0% in the prior year. This increase resulted from general cost inflation as well as from the company's restructuring efforts designed to improve long-run manufacturing and operating costs. K-C reports 2012 net operating profit after taxes (NOPAT) of $1,996 million [($2,686 million + $176 million) − ($768 million + {$284 million − $18 million} × 37%)] or $1,828 million + [($284 million − $18 million) × (1 − 37%)] and a net operating profit margin (NOPM) of 9.48% ($1,996 million/$21,063 million) of sales.[1] P&G, by contrast, is able to use its higher gross profit margin to fund a higher level of advertising and other SGA expenditures, resulting in a NOPM of 13.3%, computed as $11,174 million/$84,167 million.

[1] We include equity income of $176 million (labeled as "share of net income of equity companies" in K-C's income statement) as operating because it relates to investments in paper-related companies and it, therefore, aligns with K-C's primary operating activities. This amount is reported by K-C net of tax, and therefore, no tax adjustment is necessary when computing NOPAT.

Pension Costs. Kimberly-Clark's marketing, research and general expenses include $122 million of pension expense. This is reported in the following table in the pension footnote:

Components of Net Periodic Benefit Cost						
Year Ended December 31 (Millions of dollars)	Pension Benefits			Other Benefits		
	2012	2011	2010	2012	2011	2010
Service cost	$ 45	$ 57	$ 56	$15	$14	$14
Interest cost	279	307	309	36	41	44
Expected return on plan assets[a]	(329)	(345)	(336)	—	—	—
Amortization of prior service cost and transition amount	(4)	6	5	(1)	1	3
Recognized net actuarial loss	111	94	99	1	—	1
Settlements	20	—	—	—	—	—
Net periodic benefit cost	$122	$119	$133	$51	$56	$62

[a] The expected return on plan assets is determined by multiplying the fair value of plan assets at the remeasurement date, typically the prior year-end (adjusted for estimated current year cash benefit payments and contributions), by the expected long-term rate of return.

For 2012, the expected return on pension investments ($329 million) provides an offset to the company's pension service and interest costs ($45 million and $279 million, respectively). Footnotes reveal that Kimberly-Clark's pension investments realized an *actual* return of $556 million in 2012 (from the pension footnote in its 10-K report). So, for 2012, use of the expected return results in an unrecognized *gain* that is deferred, along with other unrecognized gains and losses, in the computation of reported profit.

Kimberly-Clark describes how it determines the expected return in its footnotes. It is instructive to review the company's rationale and, thus, the footnote follows:

> Strategic asset allocation decisions are made considering several risk factors, including plan participants' retirement benefit security, the estimated payments of the associated liabilities, the plan funded status, and Kimberly-Clark's financial condition. The resulting strategic asset allocation is a diversified blend of equity and fixed income investments. Equity investments are typically diversified across geographies and market capitalization. Fixed income investments are diversified across multiple sectors including government issues and corporate debt instruments with a portfolio duration that is consistent with the estimated payment of the associated liability. Actual asset allocation is regularly reviewed and periodically rebalanced to the strategic allocation when considered appropriate. The expected long-term rate of return is evaluated on an annual basis. In setting this assumption, we consider a number of factors including projected future returns by asset class relative to the current asset allocation. The weighted-average expected long-term rate of return on pension fund assets used to calculate pension expense for the Principal Plans was 6.68 percent in 2012 compared with 7.35 percent in 2011 and will be 6.43 percent in 2013.

The expected return on pension assets offsets service and interest costs, and serves to reduce pension expense. In general, increasing (decreasing) the expected return on pension assets, increases (decreases) profit. In 2012, K-C reduced its expected return from 7.14% to 6.49% (65 basis points). The discount rate (used to compute the interest cost component of pension expense) declined by 64 basis points (5.51% to 4.87%).

Transitory versus Persistent Line Items

Expenses relating to restructuring activities have become increasingly common in the past two decades. In its MD&A section of its 2012 10-K, Kimberly-Clark announced the following restructuring plan ($ in millions):

> On October 23, 2012, we approved strategic changes related to our Western and Central European consumer and professional businesses to focus our resources and investments on stronger market positions and growth opportunities. We will be exiting the diaper category in that region, with the

continued

exception of the Italian market, and divesting or exiting some lower-margin businesses, mostly in consumer tissue, in certain markets . . . The businesses that will be exited or divested generate annual net sales of approximately $500 and negligible operating profit. Restructuring actions related to the strategic changes will involve the sale or closure of five of our European manufacturing facilities and a streamlining of our administrative organization. In total, these actions will result in reducing our European workforce by approximately 1,300 to 1,500 positions. The restructuring actions commenced in the fourth quarter of 2012 and are expected to be completed by December 31, 2014. The restructuring is expected to result in cumulative charges of approximately $250 to $350 after tax ($300 to $400 pre-tax) over that period. Cash costs related to severance and other expenses are expected to account for approximately 50 to 60 percent of the charges. Noncash charges will consist primarily of asset impairment charges and incremental depreciation.

These initiatives are designed to further improve the company's competitive position by accelerating investments in targeted growth opportunities and strategic cost reductions to streamline manufacturing and administrative operations.

Classification of these charges as transitory or persistent is a judgment call. In K-C's case, these charges relate to a multi-year program that is expected to continue through 2014. Therefore, we classify these expenses as persistent. Our review of the financial statements did not identify any other transitory items and thus, we classified all other activity as persistent.

Earnings per Share

Net income attributable to Kimberly-Clark has increased from $1,591 million in 2011 to $1,750 million in 2012. Basic (diluted) earnings per share increased from $4.02 ($3.99) to $4.45 ($4.42). Following is Kimberly-Clark's computation of earnings per share:

Earnings Per Share A reconciliation of the average number of common shares outstanding used in the basic and diluted EPS computations follows:

Average Common Shares Outstanding (Millions)	2012	2011	2010
Average shares outstanding	**393.0**	395.4	411.3
Participating securities	**—**	0.3	1.1
Basic	**393.0**	395.7	412.4
Dilutive effect of stock options	**1.8**	1.6	1.1
Dilutive effect of restricted share unit awards	**1.3**	1.3	0.9
Diluted	**396.1**	398.6	414.4

Options outstanding that were not included in the computation of diluted EPS mainly because their exercise price was greater than the average market price of the common shares are summarized below:

Description	2012	2011	2010
Average number of share equivalents (millions)	**1.1**	3.6	13.9
Weighted-average exercise price	**$78.54**	$71.49	$66.00
Options outstanding at year-end (millions)	**1.7**	3.0	14.7

The number of common shares outstanding as of December 31, 2012, 2011 and 2010 was 389.3 million, 395.7 million and 406.9 million, respectively.

Most of the difference between basic and diluted earnings per share usually arises from the dilutive effects of employee stock options. (We should note that if stock options are *under water*, meaning that K-C's stock price is lower than the exercise price of the options, they are considered *antidilutive*, meaning that including them would increase EPS. Accordingly, they are excluded in the diluted EPS computation, but remain potentially dilutive if K-C's stock price subsequently rises above the exercise price of the options.) Although not present for Kimberly-Clark, convertible debt and preferred shares are also potentially dilutive for many companies.

Income Taxes

Kimberly-Clark's net income has been negatively affected over the past three years by an increase in its effective tax rate from 30.9% to 31.7% as K-C describes in the following footnote:

Year Ended December 31	2012	2011	2010
Tax at U.S. statutory rate applied to income before income taxes	35.0%	35.0%	35.0%
State income taxes, net of federal tax benefit	1.7	1.8	1.8
Statutory rates other than U.S. statutory rate	(2.8)	(2.3)	(3.0)
Other—net[a]	(2.2)	(4.3)	(2.9)
Effective income tax rate	31.7%	30.2%	30.9%

[a] Other—net is comprised of numerous items, none of which is greater than 1.75 percent of income before income taxes.

Common-Size Income Statement

It is useful for analysis purposes to prepare common-size statements. Exhibit C.2 shows Kimberly-Clark's common-size income statement covering the two most recent years.

EXHIBIT C.2 Kimberly-Clark Common-Size Income Statement

Year Ended December 31	2012*	2011*
Net sales	**100.0%**	100.0%
Cost of products sold	**68.0**	70.5
Gross profit	**32.0**	29.5
Marketing, research and general expenses	**19.3**	18.0
Other (income) and expense, net	**0.0**	(0.2)
Operating profit	**12.8**	11.7
Interest income	**0.1**	0.1
Interest expense	**(1.3)**	(1.3)
Income before income taxes and equity interests	**11.5**	10.5
Provision for income taxes	**(3.6)**	(3.2)
Income before equity interests	**7.8**	7.3
Share of net income of equity companies	**0.8**	0.8
Net income	**8.7**	8.1
Net income attributable to noncontrolling interests	**(0.4)**	(0.4)
Net income attributable to Kimberly-Clark Corporation	**8.3%**	7.6%

* All percentages are computed by dividing each income statement line item by that year's net sales.

The gross profit margin increased from 29.5% in 2011 to 32.0% in 2012. This increase, while seemingly minor, is significant given the competitive environment in which K-C operates. The increased gross profit was partially offset by an increase in marketing, research and general expense from 18% of sales in 2011 to 19.3% in 2012. Accordingly, 2012 income before taxes increased by 1.0 percentage point relative to 2011, from 10.5% of sales to 11.5%. Finally, net income as a percentage of sales increased by 0.6 percentage points from 8.1% of sales to 8.7%, and net income attributable to K-C shareholders increased from 7.6% of sales in 2011 to 8.3% in 2012.

Management Discussion and Analysis

The Management Discussion and Analysis section of a 10-K is usually informative for interpreting company financial statements and for additional insights into company operations. To illustrate, Kimberly-Clark provides the following analysis of its operating results in the MD&A section of its 2012 10-K:

Overview of 2012 Results

- Net sales increased 1 percent due to increases in net selling prices and volumes, partially offset by unfavorable currency effects.
- Operating profit and net income attributable to Kimberly-Clark Corporation each increased 10 percent and diluted earnings per share increased 11 percent.
- Results in 2012 include pre-tax charges of $299, $242 after tax, related to the strategic changes in Western and Central Europe. Additionally, comparisons are impacted by $135 in pre-tax charges, $86 after tax, for the pulp and tissue restructuring actions in 2012 versus $415 in pre-tax charges, $289 after tax, in 2011.
- Cash provided by operations was $3.3 billion compared to $2.3 billion last year, with the increase primarily due to higher earnings, improved working capital and lower defined benefit pension contributions ($110 in 2012 versus $679 in 2011).

Results of Operations and Related Information *2012 versus 2011*

- Personal care net sales in North America increased 2 percent. Net selling prices rose 3 percent, driven by improved revenue realization for Huggies diapers and baby wipes. Overall volumes were down 1 percent as infant care volumes decreased mid-single digits, primarily reflecting category declines. This decrease was mostly offset by improvements in adult care volumes of mid-single digits and feminine care of low-single digits, primarily due to innovations in Depend and U by Kotex brands.

  In KCI, personal care net sales increased 8 percent despite a 5 percent decrease from unfavorable changes in currency rates. Sales volumes were up 9 percent, with high-single digit to low-double digit growth in each major region. Volume performance was strong in a number of markets, including Brazil, China, Russia, South Africa, South Korea, Vietnam and Venezuela. Overall net selling prices improved 3 percent compared to the year-ago period, driven by increases in Latin America.

  In Europe, personal care net sales increased 2 percent, despite an unfavorable currency impact of 6 percent. Sales volumes rose 10 percent, mostly due to growth in non-branded offerings, Huggies baby wipes and child care offerings.
- Consumer tissue net sales in North America were down 3 percent compared to the prior year, including a 5 percent decrease from lost sales in conjunction with pulp and tissue restructuring actions. Organic sales volumes (i.e., sales volume impacts other than lost sales from restructuring actions) were essentially flat with 2011, as gains in paper towels were offset by lower volumes in facial tissue. Overall net selling prices increased 3 percent and changes in product mix reduced net sales 1 percent.

  Consumer tissue net sales decreased 1 percent in KCI. Currency rates were unfavorable by 4 percent and lost sales in conjunction with pulp and tissue restructuring actions reduced sales volumes by 1 percent. Net selling prices increased 3 percent and changes in product mix increased net sales by 1 percent. These benefits were partially offset by decreases in organic sales volumes of 1 percent.

  In Europe, consumer tissue net sales decreased 8 percent, including an unfavorable currency impact of 5 percent. Changes in product mix, net selling prices and volumes each decreased net sales by 1 percent.
- Net sales of KCP products in North America were essentially even with the prior year. Although washroom product volumes increased, these gains were offset by lower volumes in other areas, including safety products and wipers.

  KCP net sales increased 5 percent in KCI, despite a 4 percent decrease from unfavorable changes in currency rates. Sales volumes increased 6 percent, driven by double-digit growth in Latin America, and net selling prices rose 3 percent.

  In Europe, KCP net sales decreased 9 percent. Currency rates were unfavorable by 6 percent and lost sales in conjunction with pulp and tissue restructuring actions reduced sales volumes by 4 percent. Organic sales volumes were essentially flat with 2011 and net selling prices increased 1 percent.

  Net sales of health care products increased 1 percent as sales volumes increased 2 percent and unfavorable currency effects reduced net sales by 1 percent. Medical device volumes increased 3 percent and surgical and infection prevention volumes increased 2 percent.

Business Segments

Generally accepted accounting principles require that companies disclose the composition of their operating profit by business segment. Segments are investment centers (those having both income statement and balance sheet data) that the company routinely evaluates at the chief executive level.

We outlined and discussed Kimberly-Clark's business segments at the beginning of the appendix: personal care, consumer tissue, professional & other, and health care. Following are its GAAP disclosures for each of its business segments:

Consolidated Operations by Business Segment

(Millions of dollars)	Personal Care	Consumer Tissue	Professional & Other	Health Care	Corporate & Other	Consolidated Total
Net sales						
2012	**$9,576**	**$6,527**	**$3,283**	**$1,622**	**$ 55**	**$21,063**
2011	9,128	6,770	3,294	1,606	48	20,846
2010	8,670	6,497	3,110	1,460	9	19,746
Operating profit						
2012	**1,660**	**887**	**545**	**229**	**(635)**	**2,686**
2011	1,526	775	487	219	(565)	2,442
2010	1,764	660	468	174	(293)	2,773
Depreciation and amortization						
2012	**315**	**331**	**141**	**59**	**11**	**857**
2011	296	541	187	55	12	1,091
2010	277	329	142	56	9	813
Assets						
2012	**7,014**	**5,531**	**2,739**	**2,531**	**2,058**	**19,873**
2011	6,582	5,685	2,783	2,529	1,794	19,373
2010	6,316	6,106	2,962	2,410	2,070	19,864
Capital spending						
2012	**551**	**352**	**116**	**42**	**32**	**1,093**
2011	543	255	114	53	3	968
2010	436	331	156	40	1	964

Given these data, it is possible for us to perform a rudimentary return analysis for each segment. This analysis provides insight into a company's dependence on any one segment. Following is a brief summary analysis of K-C's segment return disaggregation for 2012:

(Millions of dollars)	Personal Care	Consumer Tissue	Professional & Other	Health Care
Net sales	**$9,576**	**$6,527**	**$3,283**	**$1,622**
Operating profit	**1,660**	**887**	**545**	**229**
Assets	**7,014**	**5,531**	**2,739**	**2,531**
Operating profit margin	17.3%	13.6%	16.6%	14.1%
Year-end asset turnover	1.37	1.18	1.20	0.64
Operating profit divided by year-end assets	23.7%	16.0%	19.9%	9.0%

The intensely competitive nature and capital intensity of the health care market is evident in its low return on year-end assets (9.0%), driven primarily by its low asset turnover rate (0.64). K-C relies, to a great extent, on its personal care segment to generate income.

Balance Sheet Reporting and Analysis

Kimberly-Clark's balance sheet is reproduced in Exhibit C.3.

EXHIBIT C.3 Kimberly-Clark Balance Sheet

KIMBERLY-CLARK CORPORATION AND SUBSIDIARIES Consolidated Balance Sheet		
December 31 (Millions of dollars)	**2012**	**2011**
ASSETS		
Current assets		
Cash and cash equivalents	**$ 1,106**	$ 764
Accounts receivable, net	**2,642**	2,602
Inventories	**2,348**	2,356
Other current assets	**493**	561
Total current assets	**6,589**	6,283
Property, plant and equipment, net	**8,095**	8,049
Investments in equity companies	**355**	338
Goodwill	**3,337**	3,340
Other intangible assets	**246**	265
Long-term note receivable	**395**	394
Other assets	**856**	704
Total assets	**$19,873**	$19,373
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Debt payable within one year	**$ 1,115**	$ 706
Trade accounts payable	**2,443**	2,388
Accrued expenses	**2,244**	2,026
Dividends payable	**289**	277
Total current liabilities	**6,091**	5,397
Long-term debt	**5,070**	5,426
Noncurrent employee benefits	**1,992**	1,460
Other liabilities	**884**	1,014
Redeemable preferred and common securities of subsidiaries	**549**	547
Stockholders' Equity		
Kimberly-Clark Corporation stockholders' equity		
Preferred stock—no par value—authorized 20.0 million shares, none issued	**—**	—
Common stock—$1.25 par value—authorized 1.2 billion shares; issued 428.6 million shares at December 31, 2012 and 2011	**536**	536
Additional paid-in capital	**481**	440
Common stock held in treasury, at cost—39.3 million and 32.9 million shares at December 31, 2012 and 2011	**(2,796)**	(2,105)
Retained earnings	**8,823**	8,244
Accumulated other comprehensive income (loss)	**(2,059)**	(1,866)
Total Kimberly-Clark Corporation stockholders' equity	**4,985**	5,249
Noncontrolling interests	**302**	280
Total stockholders' equity	**5,287**	5,529
Total liabilities and stockholders' equity	**$19,873**	$19,373

Kimberly-Clark reports total assets of $19,873 million in 2012. Although 2012 current ratio is 1.08, the company is relatively illiquid because a large proportion of current assets consists of accounts receivable and inventories. Cash is 5.6% ($1,106 million/$19,873 million) of total assets at year-end 2012, up from 3.9% in 2011 but the company reports no marketable securities that can serve as another source of liquidity, if needed. The lack of liquidity is usually worrisome, but is not a serious concern in this case given Kimberly-Clark's moderate financial leverage and high level of free cash flow (see later discussion in this section).

Following is a brief review and analysis for each of Kimberly-Clark's balance sheet line items.

Accounts Receivable

Kimberly-Clark reports $2,642 million in net accounts receivable at year-end 2012. This represents 13.3% ($2,642 million/$19,873 million) of total assets, down from 13.4% in the previous year. Footnotes reveal the following additional information:

Summary of Accounts Receivable, Net ($ millions), December 31	2012	2011
Accounts receivable		
From customers	**$2,346**	$2,352
Other	**376**	328
Less allowance for doubtful accounts and sales discounts	**(80)**	(78)
Total	**$2,642**	$2,602

Most accounts receivables are from customers. This means we must consider the following two issues:

1. **Magnitude**—Receivables are generally non-interest-bearing and, therefore, do not earn a return. Further, the company incurs costs to finance them. Accordingly, a company wants to optimize its level of investment in receivables—that is, keep them as low as possible while still meeting industry specific credit policies to meet customer demands.
2. **Collectibility**—Receivables represent unsecured loans to customers. It is critical therefore, to understand the creditworthiness of these borrowers. Receivables are reported at net realizable value, that is, net of the allowance for doubtful accounts. Kimberly-Clark reports an allowance of $80 million, which includes an allowance for sales discounts. In addition, the footnotes reveal the following history of the company's allowance versus its write-offs:

		Additions		Deductions	
Description (December 31, 2012)	Balance at Beginning of Period	Charged to Costs and Expenses	Charged to Other Accounts	Write-Offs and Reclassifications	Balance at End of Period
Allowance for doubtful accounts	$57	$9	—	$6	$60

The company reported a balance in the allowance for doubtful accounts of $57 million at the beginning of 2012, which is 2.1% of gross receivables [$57 million/($2,602 million + $57 million)]. During 2012, it increased this allowance account by $9 million. This is the amount of bad debt expense that is reported in the income statement. Write-offs and reclassifications of uncollectible accounts amounted to $6 million during the year, yielding a $60 million balance at year-end, which is 2.2% of gross receivables [$60 million/($2,642 million + $60 million)]. It appears, therefore, that the company's receivables were of slightly higher quality at the start of the year relative to year end, but the difference is not great.

The allowance for doubtful accounts should always reflect the company's best estimate of the potential loss in its accounts receivable. This amount should not be overly conservative (which would understate profit), and it should not be inadequate (which would overstate profit). K-C's estimate of its potential losses results from its own (unaudited) review of the age of its receivables (older receivables are at greater risk of uncollectibility).

Inventories

Kimberly-Clark reports $2,348 million in inventories as of 2012. Footnote disclosures reveal the following inventory costing policy:

> **Inventories and Distribution Costs** For financial reporting purposes, most U.S. inventories are valued at the lower of cost, using the Last-In, First-Out (LIFO) method, or market. The balance of the U.S. inventories and inventories of consolidated operations outside the U.S. are valued at the lower of cost, using either the First-In, First-Out (FIFO) or weighted-average cost methods, or market. Distribution costs are classified as cost of products sold.

Most of its U.S. inventories are reported on a LIFO basis. Some of its U.S. inventories, as well as those outside of the U.S., are valued at FIFO or weighted-average. The use of multiple inventory costing methods for different pools of inventories is common and acceptable under GAAP.

Kimberly-Clark provides the following footnote disclosure relating to the composition of its inventories:

Summary of Inventories ($ millions), December 31	2012 LIFO	2012 Non-LIFO	2012 Total	2011 LIFO	2011 Non-LIFO	2011 Total
Inventories by major class:						
At the lower of cost determined on the FIFO or weighted-average cost methods or market:						
Raw materials	**$ 148**	**$ 346**	**$ 494**	$ 163	$ 334	$ 497
Work in process	**194**	**135**	**329**	245	126	371
Finished goods	**656**	**786**	**1,442**	708	760	1,468
Supplies and other	**—**	**314**	**314**	—	300	300
	998	**1,581**	**2,579**	1,116	1,520	2,636
Excess of FIFO or weighted-average cost over LIFO cost	**(231)**	**—**	**(231)**	(280)	—	(280)
Total	**$ 767**	**$1,581**	**$2,348**	$ 836	$1,520	$2,356

Companies aim to optimize their investment in inventories because inventory is a non-income-producing asset until sold. Inventories must also be financed, stored, moved, and insured at some cost. Kimberly-Clark reports $494 million of raw materials, which is 19% of the total of $2,579 million FIFO inventories (see table above). Work-in-process inventories amount to another $329 million, and supplies and other amount to $314 million. The bulk of its inventories, or $1,442 million (56% of total inventories), is in finished goods.

Kimberly-Clark reports its total inventory cost *at FIFO* is $2,579 million then subtracts $231 million from this amount (the *LIFO reserve*) to yield the inventories balance of $2,348 million at LIFO as reported on the balance sheet. This means that, over time, Kimberly-Clark has reduced gross profit and pretax operating profit by a cumulative amount of $231 million. This has also reduced pretax income and saved federal income tax, and generated cash flow, of approximately $85.5 million (assuming a 37% marginal tax rate and computed as $231 million × 37%). During 2012, its LIFO reserve decreased by $49 million, resulting in a $49 million increase in gross profit and pretax operating profit, and an $18.1 million ($49 million × 37%) *decrease* in cash flow from increased federal income taxes.

Property, Plant, and Equipment

Kimberly-Clark reports Property, Plant, and Equipment (PPE), net, of $8,095 million at year-end 2012:

Summary of Property, Plant and Equipment, Net, December 31	2012	2011
Property, plant and equipment:		
Land	**$ 199**	$ 193
Buildings	**2,732**	2,858
Machinery and equipment	**13,993**	14,676
Construction in progress	**732**	513
	$17,656	18,240
Less accumulated depreciation	**(9,561)**	(10,191)
Total	**$ 8,095**	$ 8,049

PPE makes up 40.7% of total assets and is the largest single asset category. Given the cost of depreciable assets of $16,725 (calculated as $13,993 million in machinery and equipment and $2,732 in buildings) million and accumulated depreciation of $9,561 million (not reported here), PPE is 57.2% depreciated assuming straight-line depreciation ($9,561 million/$16,725 million) as of 2012. This suggests these assets are older than the average age that we would expect assuming a regular replacement policy. Footnotes reveal a useful life range of 40 years for buildings and 16 to 20 years for machinery as follows:

Property and Depreciation For financial reporting purposes, property, plant and equipment are stated at cost and are depreciated on the straight-line method. Buildings are depreciated over their estimated useful lives, primarily 40 years. Machinery and equipment are depreciated over their estimated useful lives, primarily ranging from 16 to 20 years. Purchases of computer software, including external costs and certain internal costs (including payroll and payroll-related costs of employees) directly associated with developing significant computer software applications for internal use, are capitalized. Computer software costs are amortized on the straight-line method over the estimated useful life of the software, which generally does not exceed five years . . . The cost of major maintenance performed on manufacturing facilities, composed of labor, materials and other incremental costs, is charged to operations as incurred. Start-up costs for new or expanded facilities are expensed as incurred.

Again, assuming straight-line depreciation, Kimberly-Clark's 2012 depreciation expense of $828 million ($857 depreciation and amortization expense reported in its statement of cash flows, Exhibit C.5, less $29 million reported as amortization expense in footnotes not reproduced in the text, but equal to the difference in accumulated amortization) reveals that its long-term depreciable assets, as a whole, are being depreciated over an average useful life of about 20.2 years, computed as depreciable assets of $16,725 million divided by $828 million depreciation expense.

Each year, Kimberly-Clark tests PPE for impairment and records a write-down to net realizable value if the PPE is deemed to be impaired. Following is Kimberly-Clark's discussion relating to its impairment testing:

Estimated useful lives are periodically reviewed and, when warranted, changes are made to them. Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. An impairment loss would be indicated when estimated undiscounted future cash flows from the use and eventual disposition of an asset group, which are identifiable and largely independent of the cash flows of other asset groups, are less than the carrying amount of the asset group. Measurement of an impairment loss would be based on the excess of the carrying amount of the asset over its fair value. Fair value is measured using discounted cash flows or independent appraisals, as appropriate. When property is sold or retired, the cost of the property and the related accumulated depreciation are removed from the Consolidated Balance Sheet and any gain or loss on the transaction is included in income.

Other (income) and expense, net for 2012 includes $19 million in asset impairment charges.

If present, impairment losses should be treated as a transitory item. Further, we must consider the effects of such losses on current and future income statements. An impairment loss depresses current period income. Further, depreciation expense in future years is decreased because it is computed based on the asset's lower net book value (cost less accumulated depreciation) following the write-down. This will increase future period profitability. The net effect of an impairment charge, therefore, is to shift profit from the current period into future periods. However, we choose not to adjust for Kimberly-Clark's 2012 impairment charge because it is a very small amount (immaterial).

Investments in Equity Companies

K-C's balance sheet reports equity investments of $355 million at year-end 2012. This amount represents the book value of its investments in affiliated companies over which Kimberly-Clark can exert significant influence, but not control. Footnotes reveal investments in the following companies:

Investments in Equity Companies Investments in companies which the Corporation does not control but over which we have the ability to exercise significant influence and that, in general, are at least 20 percent-owned by us, are stated at cost plus equity in undistributed net income. These investments are evaluated for impairment when warranted. An impairment loss would be recorded whenever a decline in value of an equity investment below its carrying amount is determined to be other than temporary. In judging "other than temporary," we would consider the length of time and extent to which the fair value of the equity company investment has been less than the carrying amount, the near-term and longer-term operating and financial prospects of the equity company, and our longer-term intent of retaining the investment in the equity company.

Consolidation is not required unless the affiliate is "controlled." Generally, control is presumed at an ownership level of more than 50%. By this rule, Kimberly-Clark does not control any of these companies. Thus, the company uses the equity method to account for these investments. This means that only the net equity owned of these companies is reported on the balance sheet. We further discuss these investments in the section on off-balance-sheet financing.

Goodwill and Other Intangible Assets

Kimberly-Clark reports $3,337 million of goodwill and $246 million of other intangible assets at year-end 2012. This amount represents the excess of the purchase price for acquired companies over the fair market value of the acquired tangible and identifiable intangible assets (net of liabilities assumed). Under GAAP, goodwill is not systematically amortized, but is annually tested for impairment. K-C reports that the estimated useful lives for its other intangible assets range from 2 to 30 years for trademarks, 5 to 17 years for patents and developed technologies, and 5 to 16 years for other intangible assets. These other intangible assets are also tested annually for impairment and are written down to fair value if found to be impaired.

Other Assets

Kimberly-Clark reports $856 million as "other assets." There is no table detailing what assets are included in this total, but footnotes reveal the following: $224 million of time deposits, and $127 million of long-term investments and assets related to derivative financial instruments. No information is given on the remaining $505 million of other assets, but K-C likely includes part of its deferred tax assets in this line item.

Kimberly-Clark provides the following disclosure relating to deferred tax assets. Later in this appendix we discuss deferred tax liabilities.

December 31 (Millions of dollars)	2012	2011
Deferred tax assets:		
Pension and other postretirement benefits	**$ 972**	$ 756
Tax credits and loss carryforwards	**729**	812
Property, plant and equipment, net	**110**	128
Other	**492**	562
	2,303	2,258
Valuation allowance	**(215)**	(229)
Total deferred assets	**2,088**	2,029
Deferred tax liabilities:		
Pension and other postretirement benefits	**269**	206
Property, plant and equipment, net	**1,228**	1,305
Installment sales	**120**	119
Unremitted earnings	**108**	58
Other	**385**	365
Total deferred tax liablilities	**2,110**	2,053
Net deferred tax liablilities	**$ 22**	$ 24

Most of this deferred tax asset (benefit) results from pension costs recognized for tax purposes, but not yet recognized in financial statements and from tax loss carryforwards. The IRS allows companies to carry forward losses to offset future taxable income, thereby reducing future tax expense. This benefit can only be realized if the company expects taxable income in the specific entity that generated the tax losses before the carryforwards expire. If the company deems it more likely than not that the carryforwards will *not* be realized, a valuation allowance for the unrealizable portion is required (this is similar to establishing an allowance for uncollectible accounts receivable). As of 2012, Kimberly-Clark has such a valuation allowance (of $215 million). Following is its discussion relating to this allowance:

> Valuation allowances decreased $14 and $58 in 2012 and 2011, respectively, of which $3 and $36 impacted 2012 and 2011 earnings, respectively. Valuation allowances at the end of 2012 primarily relate to tax credits and income tax loss carryforwards of $1.1 billion. If these items are not utilized against taxable income, $491 of the loss carryforwards will expire from 2013 through 2032. The

continued

remaining $638 have no expiration date. Realization of income tax loss carryforwards is dependent on generating sufficient taxable income prior to expiration of these carryforwards. Although realization is not assured, we believe it is more likely than not that all of the deferred tax assets, net of applicable valuation allowances, will be realized. The amount of the deferred tax assets considered realizable could be reduced or increased due to changes in the tax environment or if estimates of future taxable income change during the carryforward period.

Tax loss carryforwards reduce income tax expense in the year they are recognized, similar to tax loss carry-backs. However, companies commonly establish both the loss carryforward and the valuation allowance concurrently. The net effect is to leave tax expense (and net income) unchanged. In future years, however, a reduction of the deferred tax asset valuation account, in anticipation of utilization of the tax carryforwards (and not as a result of their expiration), reduces tax expense and increases net income. This is a transitory increase in profit and should not be factored into projections.

Long-term Note Receivable

Kimberly-Clark holds a note receivable received from the 2012 sale of certain nonstrategic assets. The note receivable is backed by standby letters of credit, which means that there is relatively no risk associated with this note. The note receivable matures on September 30, 2014, and earns interest at LIBOR plus 75 bps. This represents a nonoperating asset (like an investment).

Current Liabilities

Kimberly-Clark reports current liabilities of $6,091 million on its year-end balance sheet for 2012 ($5,397 million in 2011), which consists of the following:

Current Liabilities ($ millions), December 31	2012	2011
Debt payable within one year	**$1,115**	$ 706
Trade accounts payable	**2,443**	2,388
Accrued expenses	**2,244**	2,026
Dividends payable	**289**	277
Total current liabilities	**$6,091**	$5,397

Regarding K-C's current liabilities, $1,404 of this amount relates to financial items, such as maturing long-term debt ($1,115 million), and dividends payable ($289 million). The remaining items in current liabilities arise from common external transactions, such as trade accounts payable and accrued expenses. These transactions are less prone to management reporting bias. We must, however, determine the presence of excessive "leaning on the trade" as a means to boost operating cash flow. K-C's trade accounts payable have not increased as a percentage of total assets (12.3%) and have only slightly increased as a percentage of sales (11.5% to 11.6%). This increase is not of concern.

The possibility of management reporting bias is typically greater for accrued liabilities, which are often estimated (and difficult to audit), involve no external transaction, and can markedly impact reported balance sheet and income statement amounts. One of Kimberly-Clark's accrued liabilities involves promotions and rebates, reported at $340 million in the footnotes as of 2012. Following is the description of its accrual policy in this area:

Sales Incentives and Trade Promotion Allowances Among those factors affecting the accruals for promotions are estimates of the number of consumer coupons that will be redeemed and the type and number of activities within promotional programs between us and our trade customers. Generally, the estimates for consumer coupon costs are based on historical patterns of coupon redemption, influenced by judgments about current market conditions such as competitive activity in specific product categories. Estimates of trade promotion liabilities for promotional program costs incurred, but unpaid, are generally based on estimates of the quantity of customer sales, timing of promotional activities and forecasted costs for activities within the promotional programs. Trade promotion programs include introductory marketing funds such as slotting fees, cooperative marketing programs, temporary price reductions, favorable end-of-aisle or in-store product displays

continued

and other activities conducted by our customers to promote our products. Promotion accruals as of December 31, 2012 and 2011 were $319 and $339, respectively. Rebate accruals are based on estimates of the quantity of products expected to be sold to specific customers, and were $340 and $344 at December 31, 2012 and 2011, respectively.

All accruals have similar effects on the financial statements: when the accrual is established the company recognizes both an expense in the income statement and a liability on the balance sheet. The company subsequently reduces the liability as payments are made. Companies can (and do) use accruals to shift income from one period to another, say by over-accruing in one period to intentionally depress current period profits, and later reducing the liability account, rather than recording an expense, to increase future period profits. Accruals are sometimes referred to as "pads." They represent a cost that has previously been charged to the income statement. They also represent an account that can absorb future costs. We need to monitor accrual accounts carefully for evidence of earnings management.

Long-Term Debt

Kimberly-Clark reports $5,826 million of long-term debt as of 2012. Footnotes reveal the following:

Long-term debt is composed of the following:

($ millions)	Weighted-Average Interest Rate	Maturities	December 31 2012	December 31 2011
Notes and debentures	5.53%	2013–2046	**$4,857**	$4,984
Dealer remarketable securities	4.22%	2013–2016	**200**	200
Industrial development revenue bonds	0.24%	2015–2034	**261**	280
Bank loans and other financings in various currencies	2.57%	2013–2047	**508**	581
Total long-term debt			**5,826**	6,045
Less current portion			**756**	619
Long-term portion			**$5,070**	$5,426

Most of its long-term financing is in the form of notes and debentures, specifically $4,857 million in 2012, which mature over the next 34 years. GAAP requires disclosure of scheduled maturities for each of the five years subsequent to the balance sheet date. Kimberly-Clark's five-year maturity schedule follows:

Scheduled maturities of long-term debt for the next five years are $756 in 2013, $523 in 2014, $343 in 2015, $46 in 2016 and $957 in 2017.

Our concern with debt maturity dates is whether or not a company is able to repay debt as it comes due. Alternatively, a company can refinance the debt. If a company is unable or unwilling to repay or refinance its debt, it must approach creditors for a modification of debt terms for those issuances coming due. Creditors are often willing to oblige but will likely increase interest rates or impose additional debt covenants and restrictions. However, if creditors deny default waivers, the company might face the prospect of bankruptcy. This highlights the importance of long-term debt maturity disclosures.

We have little concern about Kimberly-Clark's debt maturity schedule as the company has strong cash flows. It is worth noting that **Standard & Poor's** (S&P) debt rating for K-C is A. This rating is solid (described as "upper-medium grade" debt).

Noncurrent Employee Benefits and Other Obligations

Kimberly-Clark reports a (negative) funded status of its pension plan of $(1,215) million at year-end 2012 (disclosed in footnotes). This means that the company's pension plans are underfunded by that amount. This underfunding is computed as the difference between the pension benefit obligation (PBO) of $6,590 million and the fair value of the company's pension plan assets of $5,375 million (these amounts are also reported in the pension footnote not reproduced here).

The central issue with respect to pensions and other post-employment obligations, which K-C calls post-retirement obligations, is the potential demand they present on operating cash flows. Companies can tap cash from two sources to pay pension and other post-employment obligations: from the returns on plan assets (i.e., the cumulative contributions and investment returns that have not yet been paid out to beneficiaries) and/or from operating cash flow. To the extent that plan assets are insufficient to meet retirement obligations, companies must divert operating cash flows from other investment activities, potentially reducing the dollar amount of capital projects that can be funded.

We can gain insight into potential cash flow issues by comparing expected future benefit payments to the funds available to make those payments. Companies must provide these disclosures in a schedule to the pension footnotes. K-C provides the following schedule of expected payments in the footnotes to its 10-K:

Estimated Future Benefit Payments Over the next ten years, we expect that the following gross benefit payments will occur:

(Millions of dollars)	Pension Benefits	Other Benefits
2013	$ 352	$ 58
2014	354	57
2015	357	56
2016	357	57
2017	365	58
2018–2022	1,915	300

The schedule shows that K-C expects to pay out $352 million in benefits to pension beneficiaries and $58 million in health care and other post-employment benefits (OPEB) to its former employees in 2013. The schedule also reveals that the company expects these amounts to increase slightly over the next five years.

K-C also reports the following table relating to its pension and other post-employment benefit plans' assets:

Change in Plan Assets Year Ended December 31 (Millions of dollars)	Pension Benefits 2012	 2011	Other Benefits 2012	 2011
Fair value of plan assets at beginning of year	**$5,214**	$4,600	—	—
Actual return on plan assets	**556**	309	—	—
Employer contributions	**110**	679	—	—
Currency and other	**60**	(15)	—	—
Benefit payments	**(478)**	(359)	—	—
Settlements	**(87)**	—	—	—
Fair value of plan assets at end of year	**$5,375**	$5,214	—	—

In 2012, K-C contributed $110 million to its pension plan. That amount, when combined with investment returns of $556 million, was more than sufficient to cover 2012 benefit payments of $478 million. Should pension assets decline markedly as a result of severe underfunding or investment losses, K-C will need to divert operating cash flows from other investment activities into pension contributions, or to borrow funds to meet its pension obligations. Although K-C's pension obligations are under-funded (as represented by the negative funded status), its current contribution levels and investment returns are sufficient to meet its anticipated pension obligations, at least in the near future.

Other post-employment benefit obligations (future health care payments) present a different picture. Because federal law does not require minimum funding of these plans, and companies do not receive a tax deduction for such contributions, companies rarely fund OPEB plans. All of the OPEB payments to beneficiaries, therefore, must be funded by concurrent company contributions. These payments amounted to $55 million in 2012. Given K-C's $3.3 billion in operating cash flow for 2012, the $55 million cash requirement is not material. However, OPEB funding requirements have been a burden for many companies, most notably General Motors prior to its bankruptcy.

Other Liabilities

Kimberly-Clark reports the catch-all category of Other Liabilities that includes deferred income tax liabilities. The financial statement footnote is displayed above, in the deferred tax asset discussion.

Most of the noncurrent deferred tax liability ($1,228 million) arises from K-C's use of straight-line depreciation for GAAP reporting and accelerated depreciation for tax reporting. As a result, tax depreciation expense is higher in the early years of the assets' lives. This will reverse in later years for individual assets, resulting in higher taxable income and tax liability. The deferred tax liability account reflects this future expected tax expense.

Although accelerated depreciation expense for an individual asset declines over time, thus increasing taxable income and tax liability, if K-C adds new assets at a sufficient rate, the additional first-year depreciation on those assets will more than offset the reduction of depreciation expense on older assets, resulting in a long-term reduction of tax liability. That is, the deferred tax liability is unlikely to reverse in the aggregate. For this reason, some analysts treat the deferred tax liability as a "quasi-equity" account.

Still, while deferred taxes can be postponed, they cannot be eliminated. If the company's asset growth slows markedly, it will realize higher taxable income and tax liability. We need to be mindful of the potential for a "real" tax liability (requiring cash payment) when companies begin to downsize.

Redeemable Preferred and Common Securities of Subsidiary

These securities represent the sale of stock by a subsidiary of Kimberly-Clark to outside interests. Because these securities are redeemable, the subsidiary must repurchase the securities at some future point. This makes them somewhat like a liability and consequently they are not reported in K-C's stockholders' equity but, instead, are reported between liabilities and equity.

Stockholders' Equity

Kimberly-Clark reports the following statement of stockholders' equity for 2012:

Dollars in million, shares in thousands	Common Stock Issued		Additional Paid-in Capital	Treasury Stock		Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Noncontrolling Interests
	Shares	Amount		Shares	Amount			
Balance at Dec. 31, 2011	428,597	$536	$440	32,937	$(2,105)	$8,244	$(1,866)	$280
Net income in stockholders' equity	—	—	—	—	—	1,750	—	47
Other comprehensive income:								
Unrealized translation	—	—	—	—	—	—	195	20
Employee postretirement benefits, net of tax	—	—	—	—	—	—	(372)	(5)
Other	—	—	—	—	—	—	(16)	—
Stock-based awards exercised or vested	—	—	(78)	(10,492)	643	—	—	—
Income tax benefits on stock-based compensation	—	—	43	—	—	—	—	—
Shares repurchased	—	—	—	16,877	(1,333)	—	—	—
Recognition of stock-based compensation	—	—	67	—	—	—	—	—
Dividends declared ($2.96 per share)	—	—	—	—	—	(1,163)	—	(38)
Other	—	—	9	—	(1)	(8)	—	(2)
Balance at Dec. 31, 2012	428,597	$536	$481	39,322	$(2,796)	$8,823	$(2,059)	$302

K-C has issued 428,597,000 shares of its $1.25 par value common stock. The common stock account is, therefore, equal to $536 million, computed as 428,597,000 shares × $1.25. The additional paid-in capital (APIC) represents the excess of proceeds from stock issuance over par value. It includes adjustments relating to the recognition of stock-based compensation and the exercise of stock-based awards and other minor adjustments.

Kimberly-Clark's stockholders' equity is reduced by $2,796 million relating to repurchases of common stock. These treasury shares are the result of a stock purchase plan approved by K-C's board of directors, and evidences K-C's conviction that its stock is undervalued by the marketplace. The repurchased shares are held in treasury and reduce stockholders' equity by the purchase price until such time as they are reissued, perhaps to fund an acquisition or to compensate employees under a stock purchase or stock option plan (treasury shares can also be retired). During 2012, the company repurchased an additional $1,333 million of shares and issued stock amounting to $643 million for share-based compensation.

K-C compensates employees via restricted stock in addition to other forms of compensation. Under its restricted stock plan, eligible employees are issued stock, which is restricted as to sale until fully vested (owned). When issued, the market value of the restricted stock is deducted from stockholders' equity. As the employees gain ownership of the shares (that is, the restricted stock vests), a portion of this account is transferred to the income statement as compensation expense. The consequent reduction in retained earnings offsets the reduction (and increase in equity) of the restricted stock account. Stockholders' equity is, therefore, unaffected in total, although its components change.

Retained earnings increased by $1,750 million due to net income and decreased by $1,163 million due to the declaration of dividends. Accumulated other comprehensive income (AOCI), which is often aggregated with retained earnings for analysis purposes, began 2012 with a balance of $(1,866) million; this negative balance reduces stockholders' equity. During the period, this AOCI account increased (became less negative) by $195 million relating to the increase in the $US value of net assets of foreign subsidiaries. This increase in net asset value resulted from a weakened $US vis-à-vis other currencies in which the company conducts its operations in 2012. In addition, the AOCI account was decreased by $372 million relating to employee post-employment benefits adjustments and decreased (made more negative) by $16 million for activities designated as "other."

Noncontrolling Interests in Subsidiaries

K-C reports $302 million for the equity interests of noncontrolling shareholders in subsidiaries. Noncontrolling interests are shareholder claims against the net assets and cash flows of subsidiaries of the company (after all senior claims are settled). Consequently, we treat noncontrolling interest as a component of stockholders' equity.

Common-Size Balance Sheet

Similar to our analysis of the income statement, it is useful to compute common-size balance sheets. Such statements can reveal changes or relations masked by other analyses. Kimberly-Clark's common-size balance sheet covering its recent two years is shown in Exhibit C.4.

Total current assets increased from 32.4% of total assets in 2011 to 33.2% in 2012. This increase was due to an increase in cash and equivalents (from 3.9% to 5.6% of total assets) that offset declines in accounts receivable (13.4% to 13.3%) and inventories (12.2% to 11.8%). The company has reduced its operating assets, which saves working capital holding costs and decreases NOA. Net PPE decreased as a percent of total assets, from 41.5% in 2011 to 40.7% in 2012. K-C also reported reductions in goodwill and other intangible assets and a slight increase in other assets.

On the liability side, current liabilities increased as a percent of the total from 27.9% in 2011 to 30.6% in 2012. This was largely due to an increase in accrued expenses (from 10.5% to 11.3%) and debt payable within one year (3.6% to 5.6%). On balance, K-C became somewhat more financially leveraged in 2012 as stockholders' equity decreased from 28.5% of the total in 2011 to 26.6%. The relative proportions of debt and equity do not appear out of line as the ratio is less than 3 to 1.

Off-Balance-Sheet Reporting and Analysis

There are numerous assets and liabilities that do not appear on the balance sheet. Some are excluded because managers and accounting professionals only report what they can reliably measure. Others are

EXHIBIT C.4 Kimberly-Clark Common-Size Balance Sheet

December 31	2012*	2011*
Current assets		
Cash and cash equivalents	5.6%	3.9%
Accounts receivable, net	13.3	13.4
Inventories	11.8	12.2
Other current assets	2.5	2.9
Total current assets	33.2	32.4
Property, plant and equipment, net	40.7	41.5
Investments in equity companies	1.8	1.7
Goodwill	16.8	17.2
Other intangible assets	1.2	1.4
Long-term notes receivable	2.0	2.0
Other assets	4.3	3.6
Total assets	100.0%	100.0%
Current liabilities		
Debt payable within one year	5.6%	3.6%
Trade accounts payable	12.3	12.3
Accrued expenses	11.3	10.5
Dividends payable	1.5	1.4
Total current liabilities	30.6	27.9
Long-term debt	25.5	28.0
Noncurrent employee benefits	10.0	7.5
Other liabilities	4.4	5.2
Redeemable preferred and common securities of subsidiaries	2.8	2.8
Stockholders' equity		
Preferred stock—no par value		
Common stock—$1.25 par value	2.7	2.8
Additional paid-in capital	2.4	2.3
Common stock held in treasury, at cost	(14.1)	(10.9)
Retained earnings	44.4	42.6
Accumulated other comprehensive income (loss)	(10.4)	(9.6)
Total Kimberly-Clark Corporation stockholders' equity	25.1	27.1
Stockholders' equity attributable to noncontrolling interest	1.5	1.4
Total stockholders' equity	26.6	28.5
Liabilities and stockholders' equity, total	100.0%	100.0%

* Percentages are computed by dividing each balance sheet line item by that year's total assets.

excluded because of the rigidity of accounting standards. Following are some areas we might consider in our evaluation and adjustment of the Kimberly-Clark balance sheet.

Internally Developed Intangible Assets

Many brands and their corresponding values are excluded from the balance sheet. For example, consider the brand "Kleenex." Many individuals actually refer to facial tissues as Kleenex—that is successful branding! So, is the Kleenex brand reported and valued on Kimberly-Clark's balance sheet? No. That brand value cannot be reliably measured and, hence, is not included on K-C's balance sheet.

Likewise, other valuable assets are excluded from the company's balance sheet. Examples are the value of a competent management team, high employee morale, innovative production know-how, a superior supply chain, customer satisfaction, and a host of other assets.

R&D activities often create internally generated intangible assets that are mostly excluded from the balance sheet. Footnotes reveal that Kimberly-Clark spends over $356 million (1.7% of sales) on R&D to remain competitive—and, this is for an admittedly non-high-tech company. Further, K-C reveals that it spends $810 million (3.8% of sales) on advertising. Both R&D and advertising costs are expensed under GAAP as opposed to being capitalized on the balance sheet as tangible assets. These unrecognized intangible assets often represent a substantial part of a company's market value.

Equity Method Investments

Kimberly-Clark reports equity investments of $355 million at year-end 2012. These are unconsolidated affiliates over which K-C can exert significant influence (but not control) and, hence, are accounted for using the equity method. The amount reported on the balance sheet represents the initial cost of the investment, plus (minus) the percentage share of investee earnings (losses), and minus any cash dividends received. Consequently, the investment balance equals the percentage owned of the affiliates' stockholders' equity (plus any unamortized excess purchase price).

Footnotes reveal that, in sum, these K-C affiliates have total assets of $2,122 million, liabilities of $1,549 million, and stockholders' equity of $573 million. K-C's reported investment balance of $355 million in the balance sheet does not reveal the extent of the investment (assets) required to manage these companies, nor the level of potential liability exposure. For instance, if one of these affiliates falters financially, K-C might have to invest additional cash to support it rather than let it fail. Failure of an important affiliate might affect K-C's ability to finance another such venture in the future.

These investments are reported at cost, not at fair market value as are passive investments. This means that unrecognized gains and losses can be buried in such investment accounts. For example, K-C footnotes reveal the following:

> Kimberly-Clark de Mexico, S.A.B. de C.V. is partially owned by the public and its stock is publicly traded in Mexico. At December 31, 2012, our investment in this equity company was $252 million, and the estimated fair value of the investment was $3.8 billion based on the market price of publicly traded shares.

Thus, for at least one of its investments, there is an unrecognized gain of $3,548 million ($3,800 million − $252 million).

Operating Leases

Kimberly-Clark has leases classified as "operating" for financial reporting purposes. As a result, neither the lease asset nor the lease obligation are reported on its balance sheet. For example, K-C reports the following disclosure relating to its operating leases:

> **Leases** We have entered into operating leases for certain warehouse facilities, automobiles and equipment. The future minimum obligations under operating leases having a noncancelable term in excess of one year are as follows:

Year Ending December 31	(Millions of dollars)
2013	$174
2014	141
2015	109
2016	89
2017	64
Thereafter	124
Future minimum obligations	$701

These leases represent an unreported asset and an unreported liability; both amounting to $622 million. This amount is computed as follows and assumes a 4% discount rate ($ millions):

Year	Operating Lease Payment	Discount Factor (i = 0.04)	Present Value
1	$174	0.96154	$167
2	141	0.92456	130
3	109	0.88900	97
4	89	0.85480	76
5	64	0.82193	53
>5	124 [$64 for ~1.938 years]	1.88609* × 0.82193	99**
			$622

Remaining life = $124/$64 = 1.938 or 2 years
*The annuity factor for 2 years at 4% is 1.88609 (alternatively, one could compute the annuity factor using 1.938 years).
**1.88609 × 0.82193 × $64 = $99

The classification of leases as operating for financial reporting purposes often involves a rigid application of accounting rules that depend solely on the structure of the lease. A large amount of assets and liabilities is excluded from many companies' balance sheets because leases are structured as operating leases. For K-C, these excluded assets amount to $622 million. The valuation of K-C common stock (shown later) uses net operating assets (NOA) as one of its inputs. Our adjustment to the K-C balance sheet, then, would entail the addition of these assets to NOA and the inclusion of $622 million in *non*operating liabilities.

Pensions

Kimberly-Clark's pension plan is underfunded as explained earlier. Total pension obligations are $6,590 million and pension assets have a market value of $5,375 million at year-end 2012. Neither of these amounts appears on the balance sheet, but are reported in the footnotes. Only the net amount of $(1,215) appears on the balance sheet via three component amounts as identified in the following footnote disclosure:

Amounts Recognized in the Balance Sheet	
Noncurrent asset—Prepaid benefit cost	**$ 8**
Current liability—Accrued benefit cost	**(12)**
Noncurrent liability—Accrued benefit cost	**(1,211)**
Net amount recognized	**$(1,215)**

Variable Interest Entities

Footnotes reveal that Kimberly-Clark owns investments in entities that are considered to be a variable interest entity (VIE) under GAAP. These entities are typically non-stock entities, such as joint ventures, partnerships and trusts, and the accounting for these entities depends upon whether the investor is deemed to be the primary beneficiary. If so, the investor must consolidate the VIE. If not, the investor accounts for its investment using the equity method. K-C's footnote disclosure relating to these investments reports that all such VIE investments are consolidated; and thus, no adjustment is required:

> At December 31, 2012, we have a minority voting interest in a financing entity used to monetize a note receivable received from the sale of nonstrategic timberlands and related assets to a nonaffiliated buyer. We are the primary beneficiary of the entity and, accordingly, consolidate the entity in our Consolidated Financial Statements.

Derivatives

Kimberly-Clark is exposed to a number of market risks as outlined in the following footnote to its 10-K:

> As a multinational enterprise, we are exposed to risks such as changes in foreign currency exchange rates, interest rates and commodity prices. A variety of practices are employed to manage these risks, including operating and financing activities and, where deemed appropriate, the use of derivative instruments. Derivative instruments are used only for risk management purposes and not for speculation. All foreign currency derivative instruments are entered into with major financial institutions. Our credit exposure under these arrangements is limited to agreements with a positive fair value at the reporting date. Credit risk with respect to the counterparties is actively monitored but is not considered significant since these transactions are executed with a diversified group of financial institutions.

The company hedges these risks using derivatives, including forwards, options, and swap contracts. This hedging process transfers risk from K-C to another entity (called the counterparty), which assumes that risk for a fee.

The accounting for derivatives is summarized in an appendix to Module 9. In brief, the derivative contracts, and the assets or liabilities to which they relate, are reported on the balance sheet at fair market value. Any unrealized gains and losses are ultimately reflected in net income, although they can be accumulated in AOCI for a short time. To the extent that a company's hedging activities are effective, the market values of the derivatives and the assets or liabilities to which they relate are largely offsetting, as are the net gains or losses on the hedging activities. As a result, the effect of derivative activities is generally minimal on both income and equity. (It is generally only when companies use derivatives for speculative purposes that these investments markedly affect income and equity. The aim of the derivatives standard was to highlight these speculative activities and we need to read risk footnotes carefully to assess whether companies are hedging or speculating with derivatives.)

Statement of Cash Flows Reporting and Analysis

The statement of cash flows for **Kimberly-Clark** is shown in Exhibit C.5.

In 2012, K-C generated $3,288 million of operating cash flow, primarily from income (net income plus the depreciation add-back equals $2,685 million). This amount is well in excess of K-C's capital expenditures of $1,093 million. K-C used excess cash to pay $1,151 million in dividends to shareholders.

Kimberly-Clark offers the following commentary regarding its 2012 operating cash flow:

> Cash provided by operations was $3.3 billion compared to $2.3 billion last year, with the increase primarily due to higher earnings, improved working capital and lower defined benefit pension contributions ($110 in 2012 versus $679 in 2011).

Overall, the cash flow picture for Kimberly-Clark is strong: operating cash flows are more than sufficient to cover capital expenditures and acquisitions, leaving excess cash that is being returned to the shareholders in the form of dividends and share repurchases. The strength of its operating cash flows mitigates any concerns we might have regarding its relative lack of liquidity on the balance sheet.

EXHIBIT C.5 Kimberly-Clark Statement of Cash Flows

KIMBERLY-CLARK CORPORATION AND SUBSIDIARIES
Consolidated Cash Flow Statement

Year Ended December 31 (Millions of dollars)	2012	2011	2010
Operating Activities			
Net income	**$ 1,828**	$ 1,684	$ 1,943
Depreciation and amortization	**857**	1,091	813
Asset impairments	**171**	58	—
Stock-based compensation	**67**	48	52
Deferred income taxes	**224**	274	(12)
Net losses (gains) on asset dispositions	**35**	(6)	26
Equity companies' earnings in excess of dividends paid	**(27)**	(23)	(48)
Decrease (increase) in operating working capital	**119**	(262)	24
Postretirement benefits	**7**	(574)	(125)
Other	**7**	(2)	71
Cash provided by operations	**3,288**	2,288	2,744
Investing Activities			
Capital spending	**(1,093)**	(968)	(964)
Proceeds from maturity of note receivable	**—**	220	—
Proceeds from sales of investments	**23**	28	47
Investments in time deposits	**(212)**	(158)	(131)
Maturities of time deposits	**95**	141	248
Proceeds from disposition of property	**9**	51	9
Other	**(6)**	5	10
Cash used for investing	**(1,184)**	(681)	(781)
Financing Activities			
Cash dividends paid	**(1,151)**	(1,099)	(1,066)
Net increase (decrease) in short-term debt	**271**	13	(28)
Proceeds from issuance of long-term debt	**315**	839	515
Repayments of long-term debt	**(492)**	(107)	(506)
Redemption of redeemable preferred securities of subsidiary	**—**	(500)	—
Cash paid on redeemable preferred securities of subsidiary	**(28)**	(57)	(54)
Proceeds from exercise of stock options	**565**	435	131
Acquisitions of common stock for the treasury	**(1,284)**	(1,246)	(803)
Other	**2**	(19)	(48)
Cash used for financing	**(1,802)**	(1,741)	(1,859)
Effect of exchange rate changes on cash and cash equivalents	**40**	22	(26)
Increase (decrease) in cash and cash equivalents	**342**	(112)	78
Cash and cash equivalents, beginning of year	**764**	876	798
Cash and cash equivalents, end of year	**$ 1,106**	$ 764	$ 876

Independent Audit Opinion

Kimberly-Clark is subject to various audit requirements. Its independent auditor is **Deloitte & Touche LLP**, which issued the following clean opinion on K-C's 2012 financial statements:

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Kimberly-Clark Corporation:

We have audited the accompanying consolidated balance sheets of Kimberly-Clark Corporation and subsidiaries (the "Corporation") as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for each of the

continued

continued from prior page

three years in the period ended December 31, 2012. Our audits also included the financial statement schedule listed in the Index at Item 15. These financial statements and financial statement schedule are the responsibility of the Corporation's management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Kimberly-Clark Corporation and subsidiaries as of December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2012, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Corporation's internal control over financial reporting as of December 31, 2012, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 22, 2013, expressed an unqualified opinion on the Corporation's internal control over financial reporting.

Deloitte & Touche LLP
Dallas, Texas
February 22, 2013

Although this report is a routine disclosure, it should not be taken for granted. Exceptions to a clean audit report must be scrutinized. Also, any disagreements between management and the independent auditor must be documented in an SEC filing. If this occurs, it is a "red flag" that must be investigated. Management activities and reports that cannot meet usual audit standards raise serious concerns about integrity and credibility. At a minimum, the riskiness of investments and relationships with such a company markedly increases.

ASSESSING PROFITABILITY AND CREDITWORTHINESS

LO2 Assess company profitability and creditworthiness.

This section reports a profitability analysis of **Kimberly-Clark**. We begin by computing several key measures that are used in the ROE disaggregation, which is the overriding focus of this section. The ROE disaggregation process is defined in Module 4, and a listing of the ratio acronyms and definitions is in the review section at the end of the book.

K-C's 2012 net operating profit after taxes, or NOPAT, is $1,996 million, computed as ($2,686 million + $176 million) − ($768 million + [{$284 million − $18 million} × 37%]). In 2012, K-C's net operating assets, or NOA, total $10,809 million, computed as $19,873 − $1,106 − $395 − ($6,091 − $1,115 − $289) − $1,992 − $884 ($ millions). For 2011, NOA totals $11,327 million.

ROE Disaggregation

Our first step is to compute the ROE and, then, disaggregate it into its operating (return on net operating assets or RNOA) and nonoperating components. Using the computations in the previous section, the 2012 disaggregation analysis of ROE for Kimberly-Clark follows. (Many of these ratios require computation of averages, such as average assets. If we wanted to compute ratios for years prior to 2012, then we would obtain information from prior 10-Ks to compute the necessary averages for these ratios.)

ROE	=	RNOA	+	Nonoperating return
34.20%	=	18.03%	+	16.17%

where

ROE = $1,750 million /[($4,985 million + $5,249 million)/2]*
RNOA = $1,996 million/[$10,809 million + $11,327 million)/2]

*We use net income and stockholders' equity attributed to K-C shareholders.

RNOA accounts for 53% (18.03%/34.20%) of K-C's ROE. K-C successfully uses its nonoperating activities to increase its 18.03% RNOA to produce a 34.20% ROE.

Disaggregation of RNOA—Margin and Turnover

The next level analysis of ROE focuses on RNOA disaggregation. Kimberly-Clark's net operating profit margin (NOPM) and net operating asset turnover (NOAT) are as follows:

RNOA	=	NOPAT/Average Net Operating Assets	=	NOPAT/Sales	×	Sales/Average Net Operating Assets
				NOPM		NOAT
		18.03%	=	9.48%	×	1.903 (0.001 rounding difference)

where

NOPM = $1,996 million/$21,063 million
NOAT = $21,063 million/[($10,809 million + $11,327 million)/2]

Kimberly-Clark's RNOA of 18.03% consists of a net operating profit margin of 9.47% and a net operating asset turnover of 1.903 times.

Disaggregation of Margin and Turnover

This section focuses on the disaggregation of profit margin and asset turnover to better understand the drivers of RNOA. Again, understanding the drivers of financial performance (RNOA) is key to predicting future company performance. Our analysis of the drivers of operating profit margin and asset turnover for Kimberly-Clark follows (all $ in millions):

Disaggregation of NOPM	
Gross profit margin (GPM) ($6,749 million/$21,063 million)	32.0%
Marketing, research and general expense, to sales ($4,069 million/$21,063 million)	19.3%
Disaggregation of NOAT	
Accounts receivable turnover (ART) {$21,063 million/[($2,642 million + $2,602 million)/2]}	8.0
Inventory turnover (INVT) {$14,314 million/[($2,348 million + $2,356 million)/2]}	6.1
PPE turnover (PPET) {$21,063 million/[($8,095 million + $8,049 million)/2]}	2.6
Accounts payable turnover (APT) {$14,314 million/[($2,443 million + $2,388 million)/2]}	5.9
Related turnover measures	
Average collection period [$2,642 million/($21,063 million/365 days)]	45.8 days
Average inventory days outstanding [$2,348 million/($14,314 million/365 days)]	59.9 days
Average payable days outstanding [$2,443 million/($14,314 million/365 days)]	62.3 days

First, let's look at the disaggregation of NOPM. K-C reports an increase in its gross profit margin from 29.5% in 2011 to 32.0% in 2012. This increase is impressive. As K-C points out in the excerpt from its MD&A that we reproduce on page C-4, the company operates in a very competitive market that makes gross profit margins difficult to maintain. Offsetting the increase in gross profit margins, was an increase in marketing, research and general expenses as a percentage of sales from 18.0% to 19.3%, which included "higher strategic marketing spending" as K-C explains in its MD&A. Further, K-C's "administrative and research spending also increased, in part to build further capabilities and support future growth."

Next, we consider the disaggregation of NOAT. K-C's receivables turnover rate of 8.0 times corresponds to an average collection period of 45.8 days, which is reasonable considering normal credit terms. However, the more important issue here is asset productivity (turnover) instead of credit quality. This is because most of K-C's sales are to large retailers; for example, 12% of Kimberly-Clark's sales are to Walmart.

Inventories turn over 6.1 times a year, resulting in an average inventory days outstanding of 59.9 days in 2012. Inventories are an important (and large) asset for companies like Kimberly-Clark. Improved turnover is always a goal so long as the company maintains sufficient inventories to meet market demand.

K-C's property, plant, and equipment are turning over 2.6 times a year, which is about average for publicly traded companies. The issue with respect to PPET is throughput, and K-C does not discuss this aspect of its business in its financial filings.

K-C's trade accounts payable turnover is 5.9, resulting in an average payable days outstanding of 62.3 days. Because payables represent a low-cost source of financing, we would prefer to see its days payable lengthened so long as K-C is not endangering its relationships with suppliers.

Credit Analysis

Credit analysis is an important part of a complete company analysis. Following is a selected set of measures for 2012 that can help us gauge the relative credit standing of Kimberly-Clark ($ millions):

Current ratio ($6,589/$6,091)	1.08
Quick ratio ([$1,106 + $2,642]/$6,091)	0.62
Total liabilities/Equity* ([$19,873 − $5,287]/$5,287)	2.76
Long-term debt/Equity ([$5,070 + $1,115]/$5,287)	1.17
Earnings before interest and taxes/Interest expense ([$2,420 + $284]/$284)	9.52
Net operating cash flows/Total liabilities ($3,288/[$19,873 − $5,287])	0.23

*Includes noncontrolling interest as equity as we analyze the company from the perspective of all equity holders; if we prefer to examine the company from the perspective of the company's equity holders only, then we would exclude noncontrolling interest.

K-C's current and quick ratios are not particularly high, and both have decreased slightly over the past two years (not shown here). These ratios do not imply any excess liquidity, and probably do not suggest any room for a further decrease in liquidity.

K-C's financial leverage, as reflected in both the liability-to-equity and long-term-debt-to-equity ratios, is slightly above the median for all publicly traded companies. Normally, this is cause for some concern. However, Kimberly-Clark has strong operating and free cash flows that mitigate this concern.

K-C's times interest earned ratio of 9.52 is healthy, indicating a sufficient buffer to protect creditors if earnings decline. It also has relatively little off-balance-sheet exposure. Thus, we do not have any serious concerns about K-C's ability to repay its maturing debt obligations.

Summarizing Profitability and Creditworthiness

An increasingly competitive environment has diminished Kimberly-Clark's gross profit margin. Operating expense reductions have not offset this decline and its NOPAT has declined slightly as a result. Its level of net operating asset turnover is acceptable, although not stellar. K-C does not provide sufficient information for us to further assess the throughput performance of its operating assets. Finally, its leverage, although higher than average, is not of great concern given K-C's strong cash flows.

FORECASTING FINANCIAL STATEMENT NUMBERS

LO3 Forecast financial statements.

The valuation of K-C's common stock requires forecasts of NOPAT and NOA over a forecast horizon period and a forecast terminal period. Our approach is to project individual income statement and balance sheet items using the methodology we discuss in Module 11. K-C presented its 4Q results and

2013 guidance to analysts on January 25, 2013, and provided the following slide relative to its expectations for 2013 (posted on the K-C investor relations Website).

We use K-C's sales growth prediction of 5% in our forecast of the company's sales for 2013. We also make the following additional forecast assumptions:

1. We assume that operating expenses retain their 2012 relation to sales and that all operating assets and liabilities also retain their 2012 relation to sales, except as noted below.
2. We assume that the dollar value of interest income and share of net income of equity companies will remain at 2012 levels.
3. We assume that net income attributable to noncontrolling interests will be the same proportion of consolidated net income as for 2012.
4. The effective tax rate has been in the range of 30% to 32%. We use 31% in our forecast.
5. In 2012, the capital spending (CAPEX) was 5.2% of sales. We use that percentage applied to forecasted sales to estimate 2013 CAPEX.
6. Depreciation as a percentage of prior-year PPE, net was 10.3%. We use that percentage applied to prior year PPE, net to estimate 2013 depreciation expense. We assume there is no depreciation expense on the 2013 CAPEX.
7. Share repurchases have been at $1,500 million per year under a program with a cap (approved by the Board of Directors) of $3 billion. We use $1,500 million per year in our forecast for the next two years.
8. The dividend payout ratio (dividends as a percentage of net income attributable to K-C stockholders) was 65.8%. We use that dividend payout percentage applied to forecasted net income attributable to K-C stockholders. We assume that dividends payable account is related to dividends declared in the same proportion as for 2012.
9. We forecast "no change" for the following balance sheet items: investments in equity companies, goodwill, long-term notes receivable, redeemable preferred securities, common stock, APIC, and AOCI.

Our initial forecast results in total assets of $20,523 million and total liabilities and equity of $18,389 million. K-C does not hold marketable securities, thus, we do not adjust assets, but instead, we assume that the difference between forecasted assets and liabilities ($2,134 million) is made up through additional short-term financing. K-C's bond rating is "A" and we assume that the new borrowing will be at the current pre-tax bond rate of 3%. We assume that the $2,134 million in additional financing is borrowed evenly over the year. This means that interest expense is expected to increase by $32 million ([$2,134 million / 2] × 3%), from $284 million to $316 million. The increase to interest expense impacts the income statement, including taxes and net income, and then impacts the balance sheet line via retained earnings (because of the income revision). The resulting forecasts of the K-C income statement and balance sheet for 2013, reflecting these assumptions and subsequent changes, are in Exhibit C.6.

EXHIBIT C.6 Forecasts of Income Statement and Balance Sheet of Kimberly-Clark

Consolidated Income Statement ($ millions)	2012	Forecast Assumptions	2013 Est.
Net sales	$21,063	21,063 × 1.05	$22,116
Cost of products sold	14,314	22,116 × 68.0%	15,039
Gross profit	6,749	Subtotal	7,077
Marketing, research and general expenses	4,069	22,116 × 19.3%	4,268
Other (income) and expense, net	(6)	no change	(6)
Operating profit	2,686	Subtotal	2,815
Interest income	18	no change	18
Interest expense	(284)	(284) − 32*	(316)
Income before income taxes and equity interests	2,420	Subtotal	2,517
Provision for income taxes	(768)	2,517 × 31.0%	(780)
Income before equity interests	1,652	Subtotal	1,737
Share of net income of equity companies	176	no change	176
Net income	1,828	Subtotal	1,913
Net income attributable to noncontrolling interests	(78)	1,913 × 4.3%	(82)
Net income attributable to Kimberly-Clark Corporation	$ 1,750	Subtotal	$ 1,831

* See text discussion

Consolidated Balance Sheet ($ millions)	2012	Forecast Assumptions	2013 Est.
Current assets			
Cash and cash equivalents	$ 1,106	22,116 × 5.3%	$ 1,172
Accounts receivable, net	2,642	22,116 × 12.5%	2,765
Inventories	2,348	22,116 × 11.1%	2,455
Other current assets	493	22,116 × 2.3%	509
Total current assets	6,589	Subtotal	6,901
Property, plant and equipment, net	8,095	8,095 + 1,150 − 834	8,411
Investments in equity companies	355	no change	355
Goodwill	3,337	no change	3,337
Other intangible assets	246	246 − 29	217
Long-term notes receivable	395	no change	395
Other assets	856	22,116 × 4.1%	907
Total assets	$19,873	Subtotal	$20,523
Current Liabilities			
New financing		plug	$ 2,146
Debt payable within one year	$ 1,115	from debt footnote	756
Trade accounts payable	2,443	22,116 × 11.6%	2,565
Accrued expenses	2,244	22,116 × 10.7%	2,366
Dividends payable	289	1,205 × 25.1%	302
Total current liabilities	6,091	Subtotal	8,135
Long-term debt	5,070	5,070 − 756	4,314
Noncurrent employee benefits	1,992	22,116 × 9.5%	2,101
Other liabilities	884	22,116 × 4.2%	929
Redeemable preferred and common securities of subsidiaries	549	no change	549
Stockholders' equity			
Preferred stock, no par value, authorized 20.0 million shares, none issued	0	no change	0
Common stock, $1.25 par value, authorized 1.2 billion shares; issued 428.6 million shares at December 31, 2012 and 2011	536	no change	536
Additional paid-in capital	481	no change	481
Common stock held in treasury, at cost: 39.3 million and 32.9 million shares at December 31, 2012 and 2011	(2,796)	(2,796) − 1,500	(4,296)
Retained earnings	8,823	8,823 + 1,831 − 1,205	9,449
Accumulated other comprehensive income (loss)	(2,059)	no change	(2,059)
Total Kimberly-Clark Corporation stockholders' equity	4,985	Subtotal	4,111
Noncontrolling interests	302	302 + 82	384
Total stockholders' equity	5,287	Subtotal	4,495
Liabilities and stockholders' equity, total	$19,873	Subtotal	$20,523

The forecasted statement of cash flows is in Exhibit C.7. This forecasted statement utilizes the forecasted income statement and comparative balance sheets as presented in Exhibit C.6 and is prepared as explained in Module 11. We forecast that K-C will generate $2,886 million in cash from operating activities in 2013. Given projected CAPEX of $1,150 million, dividends of $1,203 million, and stock repurchases of $1,500 million, we forecast that K-C will require external financing of $2,146 million. The forecasted year-end cash balance of $1,172 million is equal to 5.3% of estimated sales, the same relation to sales that the company reported in 2012.

EXHIBIT C.7 Forecast of Statement of Cash Flows for Kimberly-Clark

$ millions	Forecast Assumptions	2013 Est.
Operating activities		
Net income including noncontrolling interests	via forecasted income statement	$1,913
Add: Depreciation	8,095 × 10.3%	834
Add: Amortization	no change	29
Change in accounts receivable	2,642 − 2,765	(123)
Change in inventories	2,348 − 2,455	(107)
Change in other current assets	493 − 509	(16)
Change in other long-term assets	856 − 907	(51)
Change in accounts payable	2,565 − 2,443	122
Change in accrued expenses	2,366 − 2,244	122
Change in dividends payable	302 − 289	13
Change in noncurrent employee benefits	2,101 − 1,992	109
Change in other liabilities	929 − 884	45
Net cash from operating activities	subtotal	2,890
Investing activities		
Capital expenditures	22,116 × 5.2%	(1,150)
Net cash from investing activities	subtotal	(1,150)
Financing activities		
Dividends	1,831 × 0.658	(1,205)
Stock purchase	company guidance	(1,500)
Payments of long-term debt	2012 current maturities of LTD	(1,115)
New financing	plug	2,146
Net cash from financing activities	subtotal	(1,674)
Net change in cash	subtotal	66
Beginning cash	from balance sheet	1,106
Ending cash	subtotal	$1,172

VALUING EQUITY SECURITIES

This section estimates the values of Kimberly-Clark's equity and common stock per share.

LO4 Describe and illustrate the valuation of firm equity.

Parsimonious Forecast

For valuation purposes we must forecast the financial statements for more than one year ahead. In particular, we need NOPAT and NOA for the forecast horizon and for the terminal period. Exhibit C.8 displays the parsimonious forecast for Kimberly Clark. The methods used in this forecasting process follow those described in the module on forecasting.

We assume a sales growth of 5%, consistent with our detailed forecast above and for the terminal year, we assume a sales growth of 1%. We use the year-end NOPM (9.48%) and year-end NOAT (1.95) to forecast the following:

EXHIBIT C.8 Kimberly-Clark Multiyear Forecasts of Sales, NOPAT and NOA

($ millions)	Reported 2012	Horizon Period 2013	2014	2015	2016	Terminal Period 2017
Net sales growth.		5.0%	5.0%	5.0%	5.0%	1.0%
Net sales (unrounded) . .	$21,063	**$22,116.15** ($21,063 × 1.05)	**$23,221.96** ($22,116.15 × 1.05)	**$24,383.06** ($23,221.96 × 1.05)	**$25,602.21** ($24,383.06 × 1.05)	**$25,858.23** ($25,602.21 × 1.01)
Net sales (rounded)	$21,063	**$22,116**	**$23,222**	**$24,383**	**$25,602**	**$25,858**
NOPAT[1].	$1,996	**$2,097** ($22,116 × 0.0948)	**$2,201** ($23,222 × 0.0948)	**$2,312** ($24,383 × 0.0948)	**$2,427** ($25,602 × 0.0948)	**$2,451** ($25,858 × 0.0948)
NOA[2].	$10,809	**$11,342** ($22,116/1.95)	**$11,909** ($23,222/1.95)	**$12,504** ($24,383/1.95)	**$13,129** ($25,602/1.95)	**$13,261** ($25,858/1.95)

[1] Forecasted NOPAT = Forecasted net sales (rounded) × 2012 NOPM
[2] Forecasted NOA = Forecasted net sales (rounded)/2012 NOAT

Discounted Cash Flow Valuation

Exhibit C.9 shows the discounted cash (DCF) model results. In addition to the forecasted NOPAT and NOA from Exhibit C.8, we assume a discount rate (WACC) of 5.8%, which we obtained from Bloomberg. We use shares outstanding of 389.3 million (from the balance sheet), net nonoperating obligations (NNO) of $5,522 million calculated as: $1,115 + $289 + $5,070 + $549 − $1,106 − $395, and noncontrolling interest of $302 (all in $ millions).

EXHIBIT C.9 Kimberly-Clark Discounted Cash Flow (DCF) Valuation

(In millions, except per share values and discount factors)	Reported 2012	Horizon Period 2013	2014	2015	2016	Terminal Period
NOPAT		$2,097	$2,201	$2,312	$2,427	$2,451
Increase in NOA		533	567	595	625	132
FCFF (NOPAT − Increase in NOA)		1,564	1,634	1,717	1,802	2,319
Discount factor $[1/(1 + r_w)^t]$		0.94518	0.89336	0.84439	0.79810	
Present value of horizon FCFF		1,478	1,460	1,450	1,438	
Cum present value of horizon FCFF.	$ 5,826					
Cum present value of terminal FCFF	38,558[a]					
Total firm value	44,384					
Less: NNO	5,522					
Less: NCI	302					
Firm equity value	38,560					
Shares outstanding	389.3					
Stock value per share.	$ 99.05					

[a] Computed as $\dfrac{\left(\dfrac{\$2{,}319 \text{ million}}{0.058 - 0.01}\right)}{(1.058)^4}$

The DCF valuation model yields a stock price estimate of $99.05 per share. The mean price target for 18 analysts who publicly reported their forecasts, is $100.50 with a high of $115.00 and a low of $86.00. Our estimate is within that range. The average analyst's buy-sell recommendation is 3.1 on a scale of 1.0–5.0, indicating a hold recommendation, which we can infer to mean that K-C's stock price was fairly priced that day.

Residual Operating Income Valuation

Exhibit C.10 reports estimates of the values of Kimberly-Clark's equity and common stock per share using the residual operating income (ROPI) model. All of the assumptions remain the same as for the DCF model, above.

EXHIBIT C.10 Kimberly-Clark Residual Operating Income (ROPI) Valuation

(In millions, except per share values and discount factors)	2012	Horizon Period 2013	2014	2015	2016	Terminal Period
NOPAT		$2,097	$2,201	$2,312	$2,427	$2,451
NOA		11,342	11,909	12,504	13,129	13,261
ROPI (NOPAT − [$NOA_{Beg} \times r_w$])		1,470	1,543	1,621	1,702	1,690
Discount factor [$1/(1 + r_w)^t$]		0.94518	0.89336	0.84439	0.79810	
Present value of horizon ROPI		1,389	1,378	1,369	1,358	
Cum present value of horizon ROPI	$ 5,494					
Present value of terminal ROPI	28,100[a]					
NOA	10,809					
Total firm value	44,403					
Less: NNO	5,522					
Less: NCI	302					
Firm equity value	38,579					
Shares outstanding	389.30					
Stock value per share	$ 99.10	($0.05 difference from DCF due to rounding)				

[a] Computed as $\dfrac{\left(\dfrac{\$1{,}690 \text{ million}}{0.058 - 0.01}\right)}{(1.058)^4}$

Sensitivity Analysis of Valuation Parameters

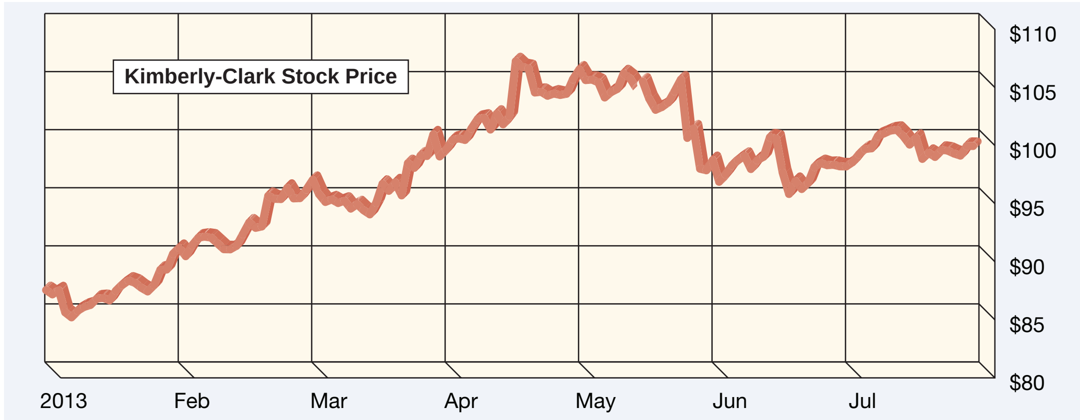
We estimate Kimberly-Clark's equity value at $38,579 million as of December 2012, which implies a per share value estimate of $99.10. As expected, equity value estimates are identical (minor difference due to rounding) for both models (because K-C is assumed to be in a steady state, that is, NOPAT and NOA growing at the same rate and, therefore, RNOA is constant).

Our stock price estimate uses only one set of assumptions and derives only one stock price. We illustrate the sensitivity of our stock price estimate to changes in input assumptions for WACC and terminal growth rate in the following table. We can expand this sensitivity analysis to any assumption or estimate we use in our financial statement adjusting, forecasting, and valuing process.

		Terminal Growth Rate				
		0.0%	0.5%	1.0%	1.5%	2.0%
WACC	4.8%	$108.03	$117.88	$130.32	$146.59	$168.67
	5.3%	$95.86	$103.48	$112.86	$124.78	$140.30
	5.8%	$85.79	$91.80	**$99.05**	$108.04	$119.40
	6.3%	$77.33	$82.14	$87.85	$94.80	$103.37
	6.8%	$70.13	$74.03	$78.60	$84.07	$90.69

Assessment of the Valuation Estimate

The closing stock price on December 31, 2012, for Kimberly-Clark (KMB) was $84.43 per share. Our model's estimates, therefore, suggest that K-C stock is undervalued as of that date. As it turns out, this valuation proved prophetic as its stock price increased to the low $90s subsequent to that date as shown in the following graph:



Summary Observations

Overall, this appendix presents a financial accounting analysis and interpretation of Kimberly-Clark's performance and position. It illustrates many of the key financial reporting topics covered in the book. We review the company's financial statements and notes, forecast key accounts, and conclude with estimates of K-C's equity value.

The Kimberly-Clark case provides an opportunity for us to apply many of the procedures conveyed in the book in a comprehensive manner. With analyses of additional companies, we become more comfortable with, and knowledgeable of, variations in financial reporting, which enhances our analysis and business decision-making skills. Our analysis of a company must go beyond the accounting numbers to include competitor and economic factors, and we must appreciate that estimation and judgment are key ingredients in financial accounting.