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General Information

The company I'm reporting on is Kraft Foods Incorporated. Kraft's corporate address is Kraft Foods Inc., Three Lakes Drive, Northfield, IL 60093-2753. With nearly $34 billion in revenues, Kraft Foods Inc. is the largest food company in North America and the second largest worldwide. From the first cup of coffee in the morning to a last late-night snack, Kraft Foods makes the world's favorite foods. Their basket of products includes six brands with more than $1 billion in revenues and a total of 61 brands with revenues of at least $100 million, is balanced across five growing global sectors: Snacks, Beverages, Cheese, Convenient Meals and Grocery. Some of the product brands within these five sectors include Nabisco, Philadelphia, Tang, Oscar Mayer, Jacobs, and Post. Kraft is the world's leading producer of cookies and crackers, including global leaders like the Oreo and Ritz brands. Kraft Foods is also one of the largest chocolate producers worldwide, with brands such as Milka and Toblerone. Brands like Life Savers, Crème Savers, Altoids, and Sugus round out their confectionery business. Estrella in Europe and Planters in North America are just two of Kraft's leading brands of salty snacks.

Kraft Foods, Inc., together with its subsidiaries, is engaged in the manufacture and sale of branded foods and beverages in the United States, Canada, Europe, Latin America and Asia Pacific. Kraft Foods Inc. conducts its global business through its subsidiaries, Kraft Foods North America, Inc. and Kraft Foods International, Inc. The company has operations in 68 countries, and sells its products in more than 145 countries. Kraft Foods

North America operates in the United States, Canada and Mexico, and manages its operations by product category, while Kraft Foods International manages its operations by geographic region. Kraft Foods North America's reportable segments are Cheese, Meals and Enhancers; Biscuits, Snacks and Confectionery; Beverages, Desserts and Cereals, and Oscar Mayer and Pizza. Kraft Foods International's reportable segments are Europe, Middle East and Africa; and Latin America and Asia Pacific.

The CEO's, Roger Deromedi and Betsy Holden**,** of Kraft Foods Inc. describe the year 2001 as being different from any previous year in their report to stockholders. Kraft integrated Nabisco and Kraft with great success, building new growth opportunities and gained more than $100 million in synergy savings. Kraft completed an initial public offering (IPO) of 16.1% of Kraft's outstanding shares, raising $8.4 billion in net proceeds used to retire debt associated with the Nabisco acquisition. Kraft began paying dividends at an annual rate of 52 cents per share and produced a total return fro shareholders of 10.6% for the 28 weeks Kraft shares were traded in 2001. New products generated more than $1.1 billion, and Kraft's volume grew 11% in developing markets around the world. More than 12 million consumers visited Kraft's websites each month for ideas and information. Productivity savings for the year met their target 3.5% of cost of goods sold. Volume grew worldwide by 3.7%, which met their stated goal of 3%-4%. Kraft operated a strong $3.3 billion in operating cash flow, and once again delivered on their promise of top-tier results, with operating company income up 8.9% to $6.1 billion, net earnings up 19.9% to $2.1 billion, and diluted earnings per share up 19.8% to $1.21.

Kraft Foods Inc. ("Kraft"), together with its subsidiaries (collectively referred to as the "Company") is the largest branded food and beverage company headquartered in the United States. My whole project will be analyzed collectively (“Company”), and not broken down into individual subsidiaries. Prior to June 13, 2001, the Company was a wholly owned subsidiary of Philip Morris Companies Inc. (“Philip Morris”). On June 13, 2001, the Company completed an initial public offering (“IPO”) of 280 million shares of its Class A common stock at a price of $31.00 per share. The IPO proceeds, net of underwriting discount and expenses of $8.4 billion, were used to retire a portion of an $11 billion long term note payable to Philip Morris incurred in the connection with the acquisition of Nabisco Holdings Corp. (“Nabisco”). After the IPO, Philip Morris owns approximately 83.9% of the outstanding shares of the Company’s capital stock through its ownership of 49.5% of the company’s Class A common stock, and 100% of the Company’s Class B common stock. The Company’s Class A common stock has one vote per share while the Company’s Class B common stock has ten votes per share. Therefore, Philip Morris holds 97.7% of the combined voting power of the Company’s outstanding common stock.

<u>Income Statement</u>

Trend in Revenue

Revenue in 2001 has jumped 28% from 2000 ($26.532 billion to $33.875 billion). This is primary due to the acquisition of Nabisco. Nabisco has brought so many new products into the Company, which in turn has made revenue jump significantly. The revenues in years prior to 2000 have a much closer relationship to each other. For instance, in 1999 the total revenue was $26.797 billion, 1998 the total revenue was $27.311 billion, and in 1997 the total revenue was $27.690 billion. As you can see the total revenues have some consistency before the year 2001. No year before 2001 had a significant jump in total revenue like the one between 2000 and 2001. Obviously the addition to Nabisco has stimulated some growth in revenue and I'm sure the Company has no problem with that. They predict that revenue will jump at least another 15% in 2002 and they hope it will keep rising for many years to come as they continue to add new products.

Trend in Expenses

There are numerous categories that make up the expenses for Kraft. These include marketing, administration and research costs (MAR), amortization of goodwill and other intangible assets, interest and other debt expenses. In the year 2001, MAR expenses jumped 30% from 2000, from 8.068 billion in 2000 to 10.498 billion in 2001. In 1999 MAR expenses were 8.1 billion. So from 1999 to 2000 MAR expenses remained within 1% of each other. Amortization of goodwill jumped almost 80%, from 535 million in 2000 to 962 million in 2001. In 1999 amortization for the year was 539 million. Once again 1999's figures are very close to that in 2000. So why the big increase from 2000 to 2001? The answer of course is Nabisco. With Nabisco came more obligations and expenses with the new products. These products need to be marketed, and research needs to be done in order to have a smooth integration of the new products with the old ones. Interest and other debt expenses have increased 140% in the last two years, from 597 million in 2000 to 1.437 billion in 2001. This is because with the acquisition of Nabisco came large note payables to Philip Morris. The financial statements of Kraft Foods Inc. before the acquisition of Nabisco had been relatively consistent, in financial terms, for many years. There was never great increases in revenues and expenses, nor were there any dramatic changes in the balance sheet and cash flow statements. But Nabisco, as I have shown and will continue to show, has changed all of that.

Changes in Accounting Practices

Effective January 1, 2001, the Company adopted Statement of Financial Accounting Standard ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities," and its related amendment, SFAS NO. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities" (collectively referred to as "SFAS No. 133"). These standards require that all derivative financial instruments be recorded on the consolidated balance sheets at their fair value as either assets or liabilities. Changes in fair values of derivatives are recorded each period in earnings or accumulated other comprehensive losses, depending on whether a derivative is designated and effective as part of a hedge transaction and, if it is, the type of hedge transaction. Gains and losses on derivative instruments reported in accumulated other comprehensive losses are included in earnings in the periods in which earnings are affected by the hedged item. As of January 1, 2001, the adoption of these new standards did not have a material effect on net income (less than $1 million) or accumulated other comprehensive losses (less than $1 million).

Earnings Per Share

EPS stands for earnings per share. This is the amount of money stockholders get per share. More specifically it is the net income earned by each share of outstanding stock. As required by FASB (Financial Accounting Standards Board), companies must report two types of EPS: basic and diluted. Basic EPS is net income, less any preferred stock dividends, divided by the weighted average number of common stock shares outstanding during the reporting period. Diluted EPS takes into account stock options, warrants, preferred stock, and convertible debt securities, all of which can be converted into common stock. These common-stock equivalents represent the potential claims of other owners on earnings, and show the investor how much of the company's earnings she's entitled to, at a minimum.

This is important stuff for investors to understand, as corporate per-share profits are, in many ways, at the core of all things financial. Per-share profits show an investor their share of a company's total profits. So diluted EPS are what the stockholders or investors are more interested in. Reported diluted and basic earnings per share, which were both $1.17 for 2001, decreases by 15.2% from 2000, due primarily to higher level of goodwill amortization of Nabisco. With the addition of Nabisco, Kraft had to takeout a large note payable so a lot more money was focused on paying that, which is why EPS dropped in 2001. Both diluted and basic EPS was $1.20 in 1999 and $1.12 in 1998. This shows that prior to 2001, EPS had been gradually rising.

Return of Assets and Profit Margin

Profit margin is a measure of the percentage of each dollar of sales that results in net income. It is computed by dividing net income by net sales. Why is this number important? Well, a company can have millions and millions of dollars worth of sales but still not make a profit. If a company's gross profit margin is a healthy number, this indicates sales dollars are being turned into profit. Analysts sometimes refer to gross profit margin simply as gross margin. Kraft Foods had a gross margin in 2001 of 10.2%, while in 2000 it was 12.9%, and in 1999 it was 11.3%. This means for every dollar in 2001 sales, Kraft had 10 cents to cover your basic operating costs and profit. While in

2000 Kraft had 13 cents from every dollar of sales. So, as you can see, there hasn't been a significant change in the gross margin over the last few years.

An overall measure of profitability is return on assets. This ratio is computed by dividing net income by average assets. The return on assets ratio (ROA) measures how well a company's management team is doing its job. A comparison of net income and average total assets, the ROA ratio reveals how much income management has been able to squeeze from each dollar's worth of a company's assets. Investors and potential investors use this ratio to evaluate a company's leadership. Many companies, particularly those involved in manufacturing and selling seasonal goods, experience wide swings in assets during the course of a year. To accommodate for these swings and produce a more accurate ratio, the total assets figure used to calculate the ROA should be an average of a firm's assets at the beginning and end of the statement period. Kraft's return on assets for 2001 was 3.4% or .03:1. This means the company is pulling in 3 cents for every dollar of assets. In 2000 the ratio was .04:1, and in 1999 was .06:1. So you can see the trend of the return on assets has dropped a little over the past couple years, from 6 cents per dollar of assets in 1999, to 4 cents per dollar of assets in 2000, and then 3 cents per dollar of assets in 2001. ROA has gone down the past few years because Kraft has experienced a decrease in net income and at the same time total assets have been increasing. With the addition of Nabisco, net income is expected to increase, as well as ROA.

Balance Sheet

Most Significant Current Assets and Current Liabilities

The most significant current assets are account receivables. This is because as the Company produces goods, they are sold on account to many stores throughout the world. Not many other current assets have changed that much over the past couple years. Accounts receivable has changed more than any other though. With the addition of Nabisco came many more items to sell the world, so it would make sense that there would be an increase in accounts receivable. About half of the current assets the Company has are accounts receivable. The next highest is their inventory (raw materials and finished product). This accounts for about 43% of total current assets. This also makes sense since with Nabisco came more inventory. The two together represent almost 93% of total current assets.

The Company's most significant current liabilities are their accrued liabilities. These include marketing liabilities, employment liabilities, and other less important liabilities. All together these accrued liabilities account for 44% of total current liabilities. Accounts payable is second, which is about 19% of total current liabilities. These are not nearly as significant as accrued liabilities. The liability that has been significant in terms of change is short-term barrowings. In 2000, short-term barrowings were $146 million and in 2001 they were $681 million. In 2000, short-term barrowings accounted for about 2% of total current liabilities. In 2001, they accounted for about 8% of total current liabilities. Short-term barrowings thus jumped 466% when talking about the actual liability change from the previous year, and 6% when considering total current liabilities. That is a pretty significant change, especially when the second highest is the liabilities due to parent and affiliates, which only had a 190% increase from 2000 to 2001.

Liquidity

Liquidity refers to how quick an asset can be converted to cash. A three-month treasury note is probably more liquid than a backhoe, but probably less liquid than money in a checking account. Users of financial statements look closely at the relationship between current assets and current liabilities. This relationship is important in evaluating a company's liquidity as well. So in this sense liquidity can also be a company's ability to pay obligations that are expected to become due within the next year or operating cycle. When current assets exceed current liabilities at the balance sheet date, the likelihood for paying the liabilities is favorable. When the reverse is true, short-term creditors may not be paid, and the company may ultimately be forced into bankruptcy.

Liquidity (Cont.)- Current Ratio

The current ratio measures the liquidity of your business by comparing current assets, short-term assets that can quickly be turned into cash, with current debt. A conservative lender or investor favors companies whose current assets are at least twice as large as current liabilities, in other words, the business has at least $2 in current assets for each $1 of current liabilities. Some credit analysts rely on a more conservative version of the current ratio known as the quick ratio. This formula does not take inventory into consideration when calculating current assets. The quick ratio recognizes the possible difficulty of converting inventory into cash to pay off short-term obligations. The Company's current ratio was .8 to 1, .9 to 1, and 1.1 to 1 in 2001, 2000, and 1999, respectively. Looking at this as an investor wouldn't leave a good impression since the current ratio is falling more each year. The main reason this is falling is because of the liabilities that came with the acquisition of Nabisco. The Company's expects to show improvement over the next couple years. This is because each year those liabilities that came with Nabisco are shrinking more and more each year.

Liquidity (Cont.)- Inventory Turnover Ratio

The inventory turnover ratio, or the cost of goods sold divided by your inventory, indicates the number of times a company's inventory is sold and replaced during a year. As an indicator, this calculation is especially useful for manufacturing companies. A high inventory turnover ratio generally means that a business is using financial resources effectively by maintaining the lowest inventory levels needed to match demand and that sales are being generated. These ratios should always be evaluated in relation to your industry average, however, as they vary considerably from industry to industry. The Company had inventory ratios of 5.79 times, 4.58 times, and 5.69 times in 2001, 2000, 1999, respectively. Not much has affected the results in this ratio over the years. In 2000, inventory went up some with the addition of Nabisco, but the cost of good sold went up in conjunction so the inventory turnover ratio wasn't effected that much.

Method of Inventory

Inventories are stated at the lower of cost or market. The last-in, first-out ("LIFO") method is used to cost substantially all domestic inventories. The cost of other inventories is principally determined by the average cost method. Now I will compare the other methods.

The first in, first-out ("FIFO") method assumes that the first unit making its way into inventory is the first sold. For example, let's say that a bakery produces 200 loafs of bread on Monday at $1 each, and 200 more on Tuesday at $1.25 each. FIFO states that if the bakery sold 200 loafs on Wednesday, the cost of goods sold is $1 per loaf because that was the cost of each the first loafs into inventory. The $1.25 loafs would be allocated to ending inventory (appears on the balance sheet).

Another method is the LIFO method. This method assumes that the last unit making its way into inventory is sold first. The outdated inventory is therefore left over at the end of the accounting period. For the 200 loafs sold on Wednesday, the same bakery company would allocate $1.25 to cost of goods sold while the remaining $1 loafs would be used to calculate the value of inventory at the end of the period.

The third method is the average cost method. This method is quite straight forward, it takes the weighted average of all units available for sale during the accounting period and then uses that average cost to determine the value of cost of goods sold and ending inventory. In our bakery example, the average cost for inventory would be $1.125 per unit, calculated as (200 x $1 + 200 x $1.25)/400.

FIFO gives us a better indication of the value of ending inventory (on the balance sheet), but it also increases net income because inventory that might be several years old is used to value cost of goods sold. Increasing net income sounds all good, but remember that it also has the potential to increase the amount of taxes that a company must pay. LIFO isn't a good indicator of ending inventory value because the left over inventory might be extremely old. This results in a valuation that is much lower than today's prices. LIFO results in lower net income because cost of goods sold is higher. Average cost produces results are somewhere in the middle between FIFO and LIFO. As I mentioned earlier, the Company uses LIFO for domestic inventory and the average cost method for the rest. The company would rather pay lower taxes, so they use the LIFO for domestic inventory. The average cost method is used in order to recognize a little more net income; this helps the company look a little more favorable to potential investors and creditors.

Method of Depreciation

The Company depreciates property, plant, and equipment and amortizes goodwill and other intangible assets using straight-line method. Through December 31, 2001, the Company used forty years to amortize goodwill and other intangible assets, in recognition of the strength of its brands, which resulted in amortization expense of $962 million for the year ended December 31, 2001. The other methods of depreciation we have discussed in class include the units-of-activity method and the declining-balance method. All have certain features that might make them be preferred by a company over the other. One thing that cannot be forgotten is the fact that no matter what depreciation method a company chooses to use, at the end of the assets life, the total amount of depreciation will be the same. Often some adjustment is made for the anticipated "residual value" that the asset may have at the end of its "useful life."

The units-of-activity method is expressed in terms of the total units of production or expected use from an asset, rather than a time period. This method has the potential to yield the lowest deprecation expense, but if that’s the case, then you will at some point in the life of the asset pay the highest (or really high) depreciation expense. This of course depends on the number of units the company produces each year. The total units of activity for the entire useful life of the asset are estimated, and these units are dived into depreciable cost. The straight-line method would yield a lower interest expense in some cases as the same amount of depreciation is used each time. So this is the main advantage of using the straight-line method of depreciation, you pay the same amount of depreciation each year. Some consider the straight-line method easier to use for simplicity sake.

With the declining-method (or double-declining balance) there is more depreciation expense recognized at the beginning, but it decreases more each year. This also called an accelerated depreciation method. The important thing to know is that this method records depreciation expense more heavily in the current years in comparison to the straight-line method. By recording more expense in the early stages of an assets useful life, the accelerated depreciation method reduces the taxable income for those years and thus reduces income taxes for those years. However, in later years, accelerated depreciation methods will record less depreciation, leaving more income. The company will therefore have to pay greater taxes. If you're a company more worried about future depreciation expense, then this is the method to use, for this method recognizes much less depreciation in the future years compared with the other methods.

The method of depreciation the company uses will affect net income of the company. When using the double-declining method you will have a lower net income at the beginning, but a higher income towards the end of the assets life. Using the straight-line method you will have the same affect on net income each period until the useful life of the asset has expired. Since the units-of-activity method is based on units of product and not a time period net income will be affected each period, but the amount of change will vary from one period to the next. When there are more units used, depreciation expense will be higher, which results in lower net income. When the number of units used is low, then depreciation expense will be lower and net income higher.

Most Significant Debt Items

The most significant debt item the company has is the debt that came with the acquisition of Nabisco. The Company had to use notes in order to obtain Nabisco. The company financed the acquisition through the issuance of two long-term notes payable to Philip Morris totaling $15 billion. As mentioned earlier, the Company has started paying off a significant portion of notes payable in 2001. The Company's total debt was $16 billion, $25.826 billion, $7.828 billion, and $7.168 billion in 2001, 2000, 1999, and 1998, respectively. There is a big increase in total debt from 1999 to 2000. This is due to the acquisition of Nabisco in 2000. The debt was cut by almost $10 billion in 2001. As mentioned earlier, On June 13, 2001, the Company completed an initial public offering ("IPO") of 280 million shares of its Class A common stock at a price of $31.00 per share, The IPO proceeds, net of underwriting discount and expenses, of $8.4 billion were used to retire a portion of an $11 billion long term note payable to Philip Morris incurred in the connection with the acquisition of Nabisco. This was the big reason for the decrease in total debt from 2000 to 2001.

Solvency

Solvency ratios measure the ability of the company to survive over a long period of time. Long-term creditors and stockholders are particularly interested in a company's ability to pay interest as it comes due and to repay the face value of debt at maturity. Debt to total assets and cash debt coverage are two ratios that provide information about debt-paying ability.

Debt to total assets ratio measures the percentage of the total assets provided by creditors. It is computed by dividing the total debt (both current and long-term liabilities) by total assets. This ratio indicates the company's ability to withstand losses without impairing the interests of creditors. The higher the percentage of debt to total assets, the greater the risk that the company may be unable to meets its maturing obligations. The Company had total debt of $16 billion, $25.826 billion, $7.828 billion, and $7.168 billion in 2001, 2000, 1999, and 1998, respectively. The Company had total assets of $55.798 billion, $52.027 billion, $30.336 billion, and $31.391 billion in 2001, 2000, 1999, and 1998, respectively. This calculates to debt to total assets ratios of 29% in 2001, 50% in 2000, 26% in 1999, and 23% in 1998. In 2000 the Company had such a high debt to total assets ratio because of the acquisition of Nabisco. The acquisition of Nabisco led to higher amounts of debts and assets, but much more debt than assets. To be more specific, between 1999 and 2000 total assets increased by almost 170%, while total debt increased by almost 330%. That is a pretty significant change from one year to the next and the acquisition of Nabisco is the reason why this occurred. The Company started to pay off a significant portion of their total debts in 2001, which is why the debt to total assets ratio dropped to 29%.

One measure of long-term solvency is the debt to total assets ratio. The cash basis measure of solvency is the cash debt coverage ratio. It is the ratio of net cash provided by operating activities to average total liabilities. This ratio demonstrates a company's ability to repay its liabilities from net cash provided by operating activities, without having to liquidate the assets employed in its operations. In 2001, the Company's net cash from operating activities was $3.328 billion and average total liabilities were 35.118 billion. This yields a cash debt coverage ratio of .095:1. This means for every dollar of liability the Company has about 10 cents to show for it. In 2000, the Company's net cash from operating activities was $3.254 billion and average total liabilities were 27.449 billion. This yields a cash debt coverage ratio of .12:1. So for every dollar of liability, the Company had 12 cents to show for it. There was no data available for 1998's total liability figure, so there is no way to calculate average total liabilities for 1999. 2001 and 2000 had very similar amounts of net cash from operating activities and average total liabilities, which is why their cash debt coverage ratios are similar. Net cash from operating activities increased a little from $3.254 billion in 2000 to $3.328 in 2001. Average total liabilities rose from $27.449 billion in 2000 to $35.118 billion in 2001. Since both categories increased by similar proportions the cash debt coverage ratio doesn't change significantly.

Stockholders' Equity

Company Stock

The Company's articles of incorporation authorize 3.0 billion shares of Class A common stock, 2.0 billion shares of Class B common stock, and 500 million shares of preferred stock. At December 31, 2001, there were 555 million Class A common stock and 1.18 billion Class B common stock shares issued and outstanding, of which Philip Morris holds 275 million Class A commons shares and all of the Class B common shares. There are no preferred shares issued and outstanding. There is also no treasury stock.

Class A common shares are entitled to one vote each while Class B common shares are entitled to 10 votes each. Therefore, Philip Morris holds 97.7% of the combined voting power of the Company's outstanding common stock. At December 31, 2001, 75,949,530 shares of common stock were reserved for stock options and other stock rewards.

The Company's Board of Directors has adopted the 2001 Kraft Performance Incentive Plan (the "Plan), which was established concurrently with the IPO. Under the Plan, the company may grant stock options, stock appreciation rights, restricted stock, reload options, and other awards based on the Company's Class A common stock, as well as performance-based annual and long-term incentive awards. Up to 75 million shares of the Company's Class A common stock may be issued under the Plan. The Company's Board of Directors granted options for 21,029,777 shares of Class A common stock concurrent with the closing date of the IPO (June 13, 2001) at the exercise price equal to the IPO price of $31.00 per share. A portion of the shares granted (18,904,637) becomes exercisable on January 31, 2003, and will expire ten years from the date of the grant. The remainder of the shares (2,125,140) may become exercisable on a schedule based on total shareholder return for the Company's Class A common stock during the three years following the date of the grant, or will become exercisable five years from the date of the grant. These options will also expire ten years from the date of the grant. Shares available to be granted under the Plan at December 31, 2001 were 54,688,173.

Dividend Policies

Dividends paid in 2001 and 2000 were 225 million and 1.0 billion, respectively. The dividends paid in 2000 reflect dividends to Philip Morris. During 2001, the Company declared two regular quarterly dividends of $0.13 per share on its Class A and Class B common stock. The present annualized dividend rate is $0.52 per common share. The declaration of dividends is subject to the discretion of the Company's board of directors and will depend on various factors, including the Company's net earnings, financial condition, cash requirements, future prospects and other factors deemed relevant by the Company's board of directors. The Company has had no stock splits or stock dividends over the years. The dividends are not cumulative.

Book Value

Book value per share is another item an investor might want to look at. Book value per share tells the equity a common stockholder has in the net assets of the corporation from owning one share of stock. It is calculated by taking the total stockholders' equity and divided by the number of common shares outstanding. Since the Company's total stockholders' equity is $23.478 billion and there were 1.735 billion shares of common stock outstanding, book value per share in 2001 was $13.53. So for every share the stockholder has, they have equity of $13.53 worth of net assets. This represents how much they own in the business.

In 2000 total stockholders' equity was $14.048 billion and there were 1,455,751,291 shares of common stock outstanding, so book value per share was $9.65. In 1999 total stockholders equity was $13.461 billion and there were 1, 455, 243, 243 shares of common stock outstanding, so the book value is $9.25. In 1998 total stockholders' equity was $15.134 billion and there were 1,455,192,308 shares of common stock outstanding, so book value per share of common stock was $10.40. Total assets have been 30.336 billion, 52.071 billion, and 55.798 billion in 1999, 2000, and 2001, respectively. The number of shares issued is the same as the number of shares outstanding since the Company had no treasury stock. So since the number of shares issued and outstanding has not been changing significantly and total assets has been rising, it appears this company is growing. With the addition of Nabisco, you can also clearly see that the Company is trying to grow. Before 2001, book value per share has remained fairly constant each and every year. But like I have been saying, the addition of Nabisco has changed the Company for the better good. This addition is good in the sense that Kraft Foods Inc. is attempting to keep up with any competitors and also continuing to grow with today's society.

Recent Company Stock Activities

The market price of the Company's stock at the beginning of the term, on February 11, 2003, was $31.57. At the end of the term, which was April 16, 2003, the market price was $28.85. From February 11, 2003 until March 11, 2003 the market price continually dropped almost each and every day. On March 10 the market price was $27.30, which was $1.55 less than what it was on the first day of the term. The main reason for the continuous decrease in market price was still due to the September 11th terrorist attack. The whole stock market has been continually falling ever since that dreadful day. Yes, there have been some surprising good days at the stock market, but it still has not recovered. Then around mid-march there were talks of a war with Iraq and suddenly the stock market was regenerated. With hopes of a quick victory in Iraq, the stock market, and the Company's stock, went on a stunning eight-day winning streak, shooting up 12 percent in value. After the eight days, the Company's stock leveled off and has remained in the $28.35-$29.00 range ever sense, finishing at $28.85 for the term.

Return on Common Stockholders' Equity

Profitability from the viewpoint of the common stockholder can be measured by the return on common stockholders' equity. This ratio shows how many dollars of net income were earned for each dollar invested by the stockholders (which is net income minus preferred stock dividends) by average common stockholders' equity. It is often reported as a percentage. Kraft Foods Inc. has no preferred stock. The Company's net income was $1.882 billion, $2.001 billion, and $1.753 billion in 2001, 2000, and 1999, respectively. The Company's average stockholders equity was $18.763 billion, $13.755 billion, and $14.298 billion for 2001, 2000, and 1999, respectively. This corresponds to a return on common stockholders' equity ratio of 10%, 14%, and 12% in 2001, 2000, and 1999, respectively. This means that for every dollar invested by common stockholders, 10% of net income is earned by the management for the stockholders, 14% in 2000, and 12% in 1999.

Price-Earnings Ratio

The price-earnings (P-E) ratio is often an oft-quoted measure of the ratio of the market price of each share of common stock to the earning per share. The P-E ratio reflects investors' assessments of a company's future earnings. It is computed by dividing the market price per share of the stock by earning per share (EPS). The P-E ratio for 2001 was 29. This is calculated by taking the closing market price of Class A common shares, which was $34.03, and dividing it by the EPS, which is $1.17. This yields a P-E ratio of 29. The Company did not actively trade stock before 2001, so there are no market prices available for years prior to 2001. 2001 is the first year that stock was actively traded, and thus market prices recorded in the annual report, so P-E ratios for previous years cannot be calculated for years prior to 2001.

Cash Flow Statement

Cash Flow Statement is used to measure your company's financial activity. It primarily looks at the inflow and outflow of cash in the corporation. The cash flow statement is designed to convert the accrual basis of accounting used to prepare the income statement and balance sheet back to a cash basis. This may sound redundant, but it is necessary. The accrual basis of accounting generally is preferred for the income statement and balance sheet because it more accurately matches revenue sources to the expenses incurred generating those specific sources. However, it also is important to analyze the actual level of cash flowing into and out of the business over a period of time. Like the income statement, the statement of cash flow measures financial activity over a period of time. The cash flow statement also tracks the effects of changes in balance sheet accounts. The cash flow statement is one of the most useful financial management tools you will have to run your business.

Net income accounts for all of a company's revenues and expenses, including some that don't represent actual cash going into or out of the company's coffers. By contrast, cash flow strips away abstractions and tells you how much cash a business is actually generating. That is the reason the cash flow statement is so much different form other statements, it shows exactly where the cash is coming from. It also can help predict future activities of the firm.

A cash flow statement will highlight activities from the income statement in a way that an income statement will not. And certainly your banker will want to see a cash flow statement showing how you have used the funds from a previous loan before they approve an extension or a new one. Without the cash flow statement, you will have an incomplete picture of your business. There are three main activities the cash flow statement looks at. They are operating activities, investing activities, and financing activities.

Two Methods of Statement Preparation

The cash flow statement can be prepared using either the direct method or the indirect method. Firms are free to choose between the direct and indirect methods, and almost all choose the indirect method even though FASB recommends the direct method. Firms chose the indirect method mainly for simplicity reasons. The direct method is more informative and might take a little more time to prepare whereas the indirect method is easier to prepare. The only activities that are different are operating, but the amount of cash provided by or used by operating activities is the same no matter which method is used**.** The other two are not affected by either method.

The direct method independently analyzes each balance sheet non-cash account for changes caused by cash transactions. Under the direct method, net cash provided by operating activities is computed by adjusting each item in the income statement from the accrual basis to the cash basis. To simplify and condense the operating activities section, only major classes of operating cash receipts and cash payments are reported. These include sales of goods and services to customers and receipts of interest and dividends on loans and investments. An efficient way to apply the direct method is to analyze the items reported in the income statement in the order in which they are listed. Cash receipts and cash payments related to these revenues and expenses are then determined. Net income is not reported in the statement of cash flow under the direct method. Under the direct method depreciation, depletion, and amortization do not appear on the statement. Gains and losses also do not appear when using the direct method.

The indirect method is a method of preparing cash flow statements in which net income is adjusted for items that did not affect cash, to determine net cash provided by operating activities. So the indirect method starts with net income on the income statement and adjusts from there. Cash transactions omitted from income are included. Non-cash transactions included in income are removed. This is called “reconciliation to Net Income." Sometime the indirect method is actually called the reconciliation method. Kraft Foods Inc. uses the indirect method, just like most other companies.

The cash flow statement is divided into three main categories:

Net cash flow from operating activities: Operating activities are the daily internal activities of a business that either require cash or generate it. They include cash collections from customers; cash paid to suppliers and employees; cash paid for operating expenses, interest and taxes; and cash revenue from interest dividends.

Operating cash flow, often referred to as working capital, is the cash flow generated from internal operations. It is the cash generated from sales of the product or service of your business. It is the real lifeblood of your business, and because it is generated internally, it is under your control.

Net cash flow from investing activities: Investing activities are discretionary investments made by management. These primarily consist of the purchases (or sale) of equipment. Investing cash flow is generated internally from *non-operating* activities. This component would include investments in plant and equipment or other fixed assets, nonrecurring gains or losses, or other sources and uses of cash outside of normal operations.

Net cash flow from financing activities: Financing cash flow is the cash to and from external sources, such as lenders, investors and shareholders. A new loan, the repayment of a loan, the issuance of stock and bonds, as well as the payment of dividends are some of the activities that would be included in this section of the cash flow statement.

To determine **operating cash flow** using the indirect method, you start with net income and add back expenses, which did not result in inflows or outflows of cash. The most common non-cash expense is depreciation. When working with historical figures, adjusting net income with depreciation and other non-cash expenses is much simpler than determining all the revenues and expenses which require or provide funds. Next, you identify all the balance sheet accounts that are associated with operations and determine the *change* in the account from the end of the last period to the end of the current period.

Operating cash flow will include all the balance sheet accounts that are a part of normal operations. Trade receivables and payables as well as accrued expenses, prepaid expenses and other current assets that are a part of day-to-day operations are included in operating cash flow.

But what about the other balance sheet accounts, how do they fit in to this picture? The remaining balance sheet accounts will either be **investing activities** or **financing activities**. Once again, you determine the change in each balance sheet account from the beginning of the period to the end of the period, tally them up, and there you have it, a complete picture of the cash flow for your company.

Noncash Investing/Financing Activities

A noncash investing/financing activity is when there is an exchange of items without the use of actual cash. An example would be when a firm issues common shares of stock for land (or some other asset). The corporation has increased their plant assets without using cash. This is a noncash investment. Other example would be converting common stock into preferred stock. These noncash investments and finances are not directly recorded on the cash flow statement since actual cash is not being used, but a firm is supposed to disclose this type of information in the form a footnote in the financial statement. The only way a noncash flow item can make it to the statement is when its recorded as an adjustment. The Company currently has no noncash investments.

Financial Overview of Kraft Foods Inc. (Cash Flow Statement)

Net Cash Provided by Operating Activities

Net cash provided by operating activities was about $3.3 billion in 2001 and 2000, while there were $2.7 billion in 1999. The increase in 2000 operating cash flows over 1999 primarily reflected increased net earnings of $248 million and reduced levels of receivables and inventories of $318 million.

Net Cash Used in Investing Activities

During 2001, 2000, and 1999, net cash used in investing activities was $1.2 billion, $16.1 billion, and $669 million, respectively. The increase in 2000 primarily reflects the cash used for the acquisition of Nabisco. The purchase of Nabisco required $15.159 billion be paid in cash, so this significantly effected the net cash figure from investment activities in 2000.

Capital expenditures, which were funded by operating activities, were $1.1 billion, $906 million, and $860 million in 2001, 2000, and 1999, respectively. The capital expenditures were primarily to modernize the manufacturing facilities, lower cost of production, and expand production capacity for growing product lines. The additional expenditures in 2001 were due primarily to the acquisition of Nabisco.

During 2001, the Company purchased coffee businesses in Romania, Morocco, and Bulgaria and also acquired confectionery businesses in Russia and Poland. The total cost of these and other smaller acquisitions was $194 million.

During 2000, the Company purchased Boca Burger, Inc. and Balance Bar Co. The total cost of these and other smaller acquisitions was $365 million.

Net Cash Used in Financing Activities

During 2001, net cash loss of $2.1 billion was used in financing activities, compared to $13 billion increase in cash in 2000. During 2001, financing activities included net debt repayments of $2.0 billion, excluding debt repayments made with IPO proceeds. The net proceeds from the IPO were used repay debt to Philip Morris and, as a result, had no impact on financing cash flows. In 2000, the Company's financing activities provided cash, as additional borrowings to finance the acquisition of Nabisco exceeded the cash used to pay dividends. In 2000, the Company had net proceeds from issuance of notes payable to parent and affiliates of $15 billion. This was a big reason why net cash from investing activities was much higher than 2001. During 1999, net cash of $2.0 billion was used in financing activities.

General Comments

What impressed me the most about the company was the number of products they are able to offer throughout the world. I am familiar with many of the brands of products that the Company produces, but I never knew that Kraft Foods was responsible for so many. Before the project when I heard the name Kraft Foods I would always think, "cheese". I thought Kraft just created cheeses and other dairy products. Doing this project opened my eyes and showed me their production goes way beyond dairy products. As I mentioned at the beginning of this report, Kraft's' basket of products includes six brands with more than $1 billion in revenues and a total of 61 brands with revenues of at least $100 million, is balanced across five growing global sectors: Snacks, Beverages, Cheese, Convenient Meals and Grocery. Some of the product brands within these five sectors include Nabisco, Philadelphia, Tang, Oscar Mayer, Jacobs, Post, Oreo, Ritz, Milka, Toblerone, Life Savers, Crème Savers, and Altoids. This to me is just amazing. That one corporation can produce so many products and I personally consume almost all these products on a regular basis. So this is what interested me the most, and hence this is the reason why I choose Kraft Foods for my project. The thing I liked least about my company was how they put together some of the aspects of their annual report.

Everything was very straightforward except for the balance sheet. They didn't do a very good job of describing the inventory method they used and why, as well as describing the method of depreciation they used and why. I thought these were very important concepts and I wanted to know about them. I used other sources instead of the annual report to find the answers I wanted. Other than that I liked the company and their operations very much. I found Kraft Foods to be very interesting and I also found this project to be very beneficial in understanding accounting principles. Learning from the textbook and on the chalkboard is one thing, but going out and actually putting the concepts I learned from class to use is much more beneficial.

If I had $20,000 to invest, I would want to invest in a company that has been around and proven themselves. I am not much of a risk taker so I would only invest in situations where I feel the company has proven to be successful time and again. I would look at certain types of data to help me make my decision, like the company's trend in revenue, net income, EPS, return on assets, profits margins, liquidity ratios, dividend policies, stock options, significant debt items, the company's book value, and stock prices. This project has helped me learn how to find at and interpret all these factors.