**Valuation: Measuring and Managing the Value of Companies**

**Henkel Integrative Case: Part II**

Reorganizing the Financials

**Introduction**

To prepare the financial statements for analysis of economic performance, you need to reorganize the items on the balance sheet, income statement, and statement of cash flows into three categories of components: operating, nonoperating, and sources of financing. This will entail searching through the notes to separate accounts that aggregate operating and nonoperating items. Although this task seems mundane, it is a crucial part in order to avoid the common traps of double-counting, omitting cash flows, or hiding leverage that artificially boosts reported performance.

**Instructions**

In this assignment, we reorganize the financial statements for Henkel AG. To do this, proceed in three steps.

1. ***Estimating Operating Profit.*** Start by determining operating profit. Our definition of operating profit, which focuses on the ongoing profit related to operations, will differ from how Henkel defines operating profits. There are three major differences.
   1. First, we need to separate “other operating income” and “other operating charges” into operating and nonoperating items, since not all of their components are ongoing and related to core operations. Evaluating whether or not a component is ongoing and related to core operations is subjective (often a long-term view and strong knowledge of the company is required). Therefore, comment on why you have classified each component a particular way. Plea se treat other/sundry items as operating.
   2. Second, adjust cost of sales, marketing, R&D, and general expenses for restructuring charges. A description of restructuring charges can be found just below the consolidated statement of income.
   3. Since EBITA should be measured before amortization of intangible, add back amortization to adjusted operating profit computed above. For Henkel, amortization is not disclosed on the income statement, but rather in a separate table at the end of the section on consolidated financial statements.
2. ***Estimating Operating Taxes.*** Next, determine the operating tax rate. Apply the operating tax rate to operating profit to determine after-tax operating profit. To find the operating tax rate, proceed in three steps.
   1. First, use the tax reconciliation table to determine the marginal tax rate. The marginal tax rate is provided by Henkel.
   2. Next, apply the marginal tax rate to EBITA to determine statutory taxes on EBITA. This will differ from the estimated tax charge. The estimated tax charge uses earnings before taxes as its base.
   3. Finally, segment the remaining tax items into operating taxes related to current, ongoing core operations and nonoperating taxes. Similar to operating income, evaluating whether or not a component is ongoing and related to core operations is subjective. Therefore, comment on why you have classified each component a particular way.
3. ***Calculating Invested Capital and Total Funds Invested.*** Next, reorganize the balance sheet into invested capital, total funds invested, and sources of financing.
   1. To determine invested capital, subtract operating liabilities (stakeholder capital) from operating assets (used for core operations). Classify excess cash (cash greater than 2% of revenues), financial assets, deferred taxes (sometimes called income tax provisions), pensions, and assets held for sales as nonoperating (either as a nonoperating asset, debt equivalent, or equity equivalent). Each of these assets (or debt/equity equivalents) is important component of final value, but must be analyzed and valued separately. Classify other operating assets and liabilities as operating. When determining invested capital, separate operating working capital from long-term (net) assets. Compute invested capital with and without goodwill and acquired intangibles.
   2. To calculate total funds invested, add nonoperating assets to invested capital. For ease of interpretation, net the company’s “financial liabilities” against “financial assets,” both current and non-current. Otherwise, treat debt and equity equivalents as sources of financing.
4. To conclude the assignment, estimate return on invested capital. Estimate ROIC with and without acquired intangibles. If the cost of capital of Henkel is 9%, is the company creating value?

**Helpful page locations, Henkel 2009 Annual Report**

* Other operating income can be found in note 6 on page 91.
* Other operating charges can be found in not e7 on page 92.
* Taxes on income (the tax reconciliation table) can be found in note 9 starting on page 92.