**Medtronic, Inc.[[1]](#footnote-1)\***

**Annual Report, Financial Analysis, Competitor Analysis**

**Final Exam**

**Introduction**

The objective of the case is to use your skills to read and understand Medtronic Inc.’s annual report and to obtain a perspective on Medtronic’s performance. The case consists of two parts. Part 1 focuses on Medtronic’s 2014 annual report and questions connected with the annual report and disclosures. Part 2 focuses on the analysis of Medtronic’s performance as of 2014 using basic financial statement analysis techniques. **Your focus of attention should be the 2010 to 2014 period.**

Materials for the case are: Medtronic Inc. 2014 annual report and Medtronic Inc. Financial Statement Analysis.

**Part 1: Medtronic Inc. 2014 Annual Report**

Below are a series of questions to answer connected with Medtronic’s 2014 annual report.

1. Revenue Recognition

Currently it takes the Company 241 days to turn a product into cash (160 days in inventory and 81 days to collect from customers). Part of Medtronic’s revenue is recognized when a medical device is actually implanted in a patient (see Footnote 1).

Suppose management wishes to reduce the average inventory holding period from the current 241 days to 200 days in order to improve its cashflow management. Management believes this can be achieved by changing the revenue recognition policies so that revenue is recorded when the medical device is delivered to the hospital resulting in an inventory decrease.

Assuming no change in 2014 COGS or 2013 ending inventory, what would the 2014 ending inventory balance need to be in order to achieve this goal? Would this change in revenue recognition improve the stated goal of decreasing the time required to turn a product into a cash collection? Explain your answer.

2. Inventory (Omit for HK 2015 Class)

The Company currently uses the FIFO inventory method (see Footnote 1). Suppose the ending LIFO inventory values are $863 million and $925 million for 2013 and 2014, respectively. Management is interested in whether they should adopt LIFO and has asked you for your recommendation. Prepare an analysis of whether LIFO would benefit shareholders. Your analysis should consider both the impact on COGS and net income as well as cashflows. Which method do you recommend the Company use and why?

(Note: Net income is an after tax number. Using the terminology of the case, net income is earnings before taxes less income taxes. Earnings per share, EPS, is also an after tax number.)

3. Property, Plant and Equipment

For a Company like Medtronic, an adequate capital budget is crucial for maintaining the capital base of the Company. Below are a series of questions to help determine the average age of the Company’s capital base and capital budget plan. Does Medtronic use straight-line or accelerated depreciation method for reporting purposes? How can you tell? What is the depreciation expense for reporting purposes for 2013 and 2014? Where did you get these numbers? Using this information and the information in Footnote 1, calculate the average age of the PPE for 2013 and 2014. What are capital expenditures for property, plant and equipment for 2013 and 2014? Where did you get these numbers? Briefly describe the capital budget plan used by the Company in terms of keeping the PPE up to date.

4. Allowance for Doubtful Accounts

The Company sells to customers on credit. For Fiscal 2014, the Company has reported $3.811 billion as the amount for accounts receivable. What does this amount represent? What is the actual amount in the accounts receivable account? Where did you get this information? Suppose management is worried about the potential credit worthiness of its customers and determines that the allowance account should have been $250 million at the end of Fiscal 2014. What would the impact of this change be on 1) the balance sheet and 2) the income statement, net income and basic earnings per share?

5. Intangibles - Goodwill

The Company provides details of its intangible assets and goodwill in Footnote 7. Suppose in 2014, management determines the goodwill value is only $9,548 million after valuing the cash flows associated with the respective business units. What impact will this have on the Company’s income statement, net income and earnings per share, and balance sheet?

6. Research and Development

Reporting rules require R&D costs to be expensed in the period in which they are incurred. Medtronic has determined that R&D expenditures have benefits that last on average 5 years. For Fiscal 2014, what is the impact on net income and rate of return on assets, if R&D was capitalized with a useful life of 5 years (instead of expensed) starting in 2010. (Hint: The R&D information needed to answer this question can be found in the Income Statement in the Medtronic 2014 annual report (2014-2013-2012 numbers) and 2012 annual report (2011-2010 numbers). Use the 2012 number from the 2014 annual report. You need to create an R&D asset and an R&D amortization expense for 2014.)

7. Taxes

For 2014, what is the provision for income taxes (or tax expense per books)? What part is current taxes payable and what part is deferred taxes? The cumulative effects of the individual differences between taxes per book and per tax return are summarized in Footnote 13. Explain how a deferred tax asset is created when the Company records an estimate for credit losses.

8. Contingencies

Footnote 1 deals with disclosures for contingencies and commitments. Because of its products, the Company has significant obligations for product warranties. Based on the information provided in the footnote, evaluate the adequacy of the warranty liability for Fiscal 2014.

9. Capital Stock

The financial statements reveal that the Company has repurchased over $2.553 billion worth of stock in Fiscal 2014 (see Footnote 11 and Statement of Cash Flows). Repurchasing shares has two effects on the earnings per share, EPS, calculation. First, it decreases the number of shares in the denominator, this increasing EPS. On the other hand, there is an opportunity cost to the Company by not having the funds available to invest in projects or other securities; as a result there is a potential decrease in revenue and hence net income. How might the repurchase affect future earnings? (Hint: you may wish to proxy for the minimum opportunity cost of forgone income assuming the Company could invest the cash in a project that would return the Company’s weighted average cost of capital, 10.1%) What affect does the repurchase have on the balance sheet (Note: this can be answered by looking at the debt to equity ratio)?

10. Leases

Footnote 15 discloses that the Company has a variety of leases, both capital and operating leases. For Fiscal 2014, if the Company were to classify their operating leases as capital leases, what additional amount would they put on the balance sheet to recognize the resulting asset and liability? What effect does this have on the debt to equity ratio?

**Part 2: Medtronic Financial Statement Analysis**

Using a standard format, the Medtronic Inc. Financial Statement Analysis document contains financial statement information and selected ratios **for the years 2011 to 2014** **for the Company.[[2]](#footnote-2)** Using the “Building Blocks” and the approach used for the International Food Distribution and Retail Case (Ahold, Carrefour, Wal-Mart); evaluate the performance of Medtronic.

**Ratios and Definitions:**

A common set of ratios is provided for Medtronic. The definitions of the ratios are contained in the Medtronic Financial Analysis document.

**Case Evaluation Criteria**

***Part I – Financial Statement Questions***

Total 100 Points

Each problem is worth 11 points.

***Part II - Case Evaluation Criteria***

Written Analysis (Total 50 Points):

*Introduction/Strategy Overview (5 Points):*

Should provide a concise overview of the company and position within the industry. Specific strategies should be identified for full points. Extra credit is given for serious discussion that shows additional insight into the company/industry.

*Building Blocks Analysis (40 Points):*

Each Building Block is worth 5 points awarded as follows:

5 – Answer references the correct ratios, shows correct analysis of both the *trend, level and meaning* of the ratio during the time period in question.

4 – Correct ratios are mentioned and analyzed correctly; however, analysis may not fully address one of trend, level or meaning.

3 – Correct Ratios are used; however, analysis is limited to a simple restating of the numbers provided in the case. Little or no interpretation of the ratio meaning is attempted.

2 – Response may include some inappropriate ratios. Limited analysis is done.

1 – Response only restates ratios, some of which are inappropriate. No analysis is included.

0 – Building Block is omitted.

*Summary/Linking Accounting to Strategy (5 Points Available):*

For full marks there should be a summary that “brings together” the building blocks and highlight the appropriate ones to be used in evaluating company performance. Should reference the company strategy and provide a basic opinion as to whether the company strategy/goals are being achieved.

Helpful Hints

If the Building Block Analysis is worth 40 points and a complete answer is worth 5 points per building block, there must be 8 building blocks.  Here is a helpful way to think about the building blocks:

1. Return on Assets
2. Return on Equity
3. DuPont Model
4. Margin Analysis and common sized income statement
5. Turnover
6. Risk – current and quick ratios with implications
7. Risk – debt to equity and EBIT interest coverage
8. Risk – cashflows to average current and to average total liabilities

While annual growth numbers are not a specific building block, they certainly merit consideration in your discussion.

You certainly can consider other information beyond the specific ratios in the case and summary table that I gave you. You obviously have some discretion about how to put your analysis together.  Nevertheless, you should reach a conclusion that ties the strategy overview (introduction) and building blocks together in the summary.

1. \* Copyright 2015 by Tippie School of Management, University of Iowa. This case was prepared by Professor Douglas DeJong for class discussion rather than to illustrate effective or ineffective handling of an administrative situation. The assistance of Christopher Small is greatly appreciated. [↑](#footnote-ref-1)
2. The Medtronic Inc. Financial Statement Analysis document contains financial statement information for the year 2010 for the Company. This information should be excluded from your analysis. [↑](#footnote-ref-2)