

Analysis of the Accounting Policies of
PepsiCo
as compared to
Coca Cola
Year-end December 31, 2001

Prepared for
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EXECUTIVE SUMMARY

In investigating PepsiCo's accounting policies for G. D. Meyers and Company, we have focused on nine major areas of the annual report, comparing PepsiCo with Coca Cola throughout our analysis. Through the *Balance Sheet*, we focused on the major assets and major liabilities of each, and discovered that the primary difference is PepsiCo's large balance of intangibles. In the *Income Statement*, we analyzed the major sources of revenue and expenses for both companies, and found that PepsiCo's recent merger with Quaker Oats accounts for a large part of the difference between the two. In the *Cash Flow Statement*, we compared the major inflows and outflows for PepsiCo and Coca Cola and discovered that PepsiCo has more outflows for the last year as compared to Coca Cola. In looking at the *Audit Report*, both companies were audited by "Big 4" accounting firms and both were issued clean opinions. In evaluating *Revenue Recognition*, we found that the two firms are comparable in the types of revenue transactions and recognition methods, although their geographic diversification varies. When looking at *Cost of Goods Sold*, we found the two to be virtually identical with regards to elements such as inventory types, inventory turnover, inventory writedowns, and more. Analyzing *Property, Plant, and Equipment* revealed that PepsiCo and Coca Cola have similar equipment and depreciation. In their *Stockholders Equity* section, we discovered that PepsiCo has a significant dilutive effect on stock options, while Coca Cola does not. Finally, we found that PepsiCo had the most tantalizing *Unusual Items*, due to its recent merger with Quaker, and that taking those items into account may help in understanding many of the numbers and analysis throughout this report.

Based on this analysis, we believe that G. D. Meyers and Company can place reliance on PepsiCo's financial statements in their decision to underwrite an additional issue of stock, although further analysis in part II of this report will clarify the matter further.

Introduction

We have been asked to prepare a report regarding background information on the current financial position of PepsiCo in order to determine whether underwriting an additional issue of stock is a sound financial decision. In particular, we will be analyzing how useful PepsiCo's financial statements are in representing the company's financial performance.

In August 2001, PepsiCo completed a major merger with Quaker Oats Company, positioning them for future growth. Thus, the information presented below from PepsiCo's financial statements will reflect the combined financial positions of PepsiCo and Quaker Oats Company as if they had always been one. PepsiCo (hereafter known as "Pepsi") has over 500 products, including fifteen distinct brands in their portfolio which each generate over \$1 billion in annual retail sales, more than any other company in its industry.

We will use information from Pepsi's 2001 annual report to determine how their accounting policies compare to those of their major competitor, Coca Cola (hereafter known as "Coke").

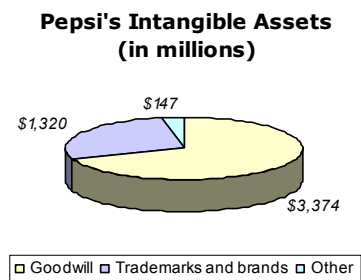
Overview of the Balance Sheet

In this section we will examine the major assets, liabilities and equities for both Pepsi and Coke.

Pepsi's two largest assets are:

1. PPE (31.7% of total assets)
2. Intangible Assets (22% of total assets)^{*}

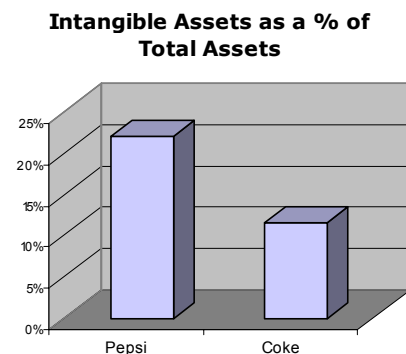
While we have found that Pepsi's intangible assets are a result of the trademarks associated with the various brands they operate, most of them can be attributed to "goodwill" due to the merger with Quaker. In fact, Pepsi's goodwill constitutes almost 70%[†] of their total intangibles.



More specifically, Pepsi's brands are broken down by size of assets. The three largest are: (1) Frito-Lay North America, (2) Frito-Lay International and (3) Gatorade/Tropicana. Pepsi's major liabilities include: Accounts payable (34.2% of total liabilities) and long term debt (20.4% of total liabilities).[‡] Pepsi's major equity figure is retained earnings of \$11,519 million.

Contrary to Pepsi's, Coke's major assets include:

1. Long-term investments (36.6% of total assets)[§]
2. Current assets (32% of total assets)[§]



^{*} Computed: PPE = \$6876M / \$21,695M = 31.7%
 Intangible assets = \$4041M / \$21,695M = 22%
[†] Computed: \$3,374M / \$4,841 = 70%
[‡] Computed: Accounts payable = \$4461M / \$13,021M = 34.2%
 Long-term debt = \$2651M / \$13,021M = 20.4%
[§] Computed: Long-term investments = \$8214M / \$22,417M = 36.6%
 Current assets = \$7171M / \$22,417M = 32%



With regard to intangibles, Coke's intangibles amount to only 11.5%^{*} of total assets, or only half that of Pepsi's intangibles. This demonstrates the relative magnitude of Pepsi's intangible asset balance. Coke's major liabilities include loans/notes payable (33.9% of total liabilities) and accounts payable/accrued expenses (17.6% of total liabilities).[†] Coke's major equity is retained earnings in the amount of \$23,443 million. Coke's retained earnings and overall stockholder equity are much larger than those of Pepsi's.

As an added measurement, we calculated Pepsi's and Coke's debt to equity ratio and current ratio.[‡]

	<i>Debt to equity ratio</i>	<i>Current ratio</i>
Pepsi	60%	117%
Coke	49.3%	85%

From these ratios, we can conclude that Pepsi uses slightly more debt than Coke to facilitate its operations (debt to equity ratio). Furthermore, based on the current ratio, we can conclude that Pepsi's assets are higher than their liabilities. Thus, they are more stable (more liquid) than Coke and are in a better financial position to cover their current liabilities without disposing of all current assets.

Overview of the Income Statement

Since both companies are in the business of manufacturing, selling and distributing products, the revenues and expenses stated on their income statements are relatively similar. We will examine the major sources of revenues, expenses, gains and losses, as well as discuss any items that are unusual on each of the company's income statements.

Pepsi's net income is \$2,662 million and their major sources of revenue include:

1. Frito-Lay North America (34.8% of net sales)
2. Frito-Lay International (19% of net sales)
3. Gatorade/Tropicana (14.9% of net sales)[§]

In addition to the above primary revenue sources, Pepsi also realized bottling equity income and transaction gains. Major expenses for Pepsi include selling, general and administrative expenses (48% of total expenses) and cost of sales (46.9% of total expenses)^{**}. Additionally, Pepsi has a line item for merger-related costs.

* Computed: $\$2,529M / \$22,417 = 11.5\%$

† Computed: Loans and notes payable = $\$3743M / \$11,051M = 33.9\%$
 Accounts payable and accrued expenses = $\$3679M / \$11,051M = 33.3\%$

‡ Computed: Debt to equity ratio (Pepsi): $\$13,021M / \$21,695M = 60\%$; Debt to equity ratio (Coke): $\$11,051M / \$22,417M = 49.3\%$
 Current ratio (Pepsi): $\$5,853M / \$4,998M = 117\%$; Current ratio (Coke): $\$7,171M / \$8,429M = 85\%$

§ Computed: Frito-Lay North America = $\$9,374M / \$26,935M = 34.8\%$
 Frito-Lay International = $\$5,130M / \$26,935M = 19\%$
 Gatorade/Tropicana = $\$4,016M / \$26,935M = 14.9\%$

** Computed: Selling, general, and administrative expenses = $\$11,608M / \$22,914M = 48\%$
 Cost of sales = $\$10,754M / \$22,914M = 46.9\%$



Though these costs are not a large amount of Pepsi's expenses (1.5% of total expenses), they reflect one of the major differences between Pepsi and Coke in relation to the income statement.

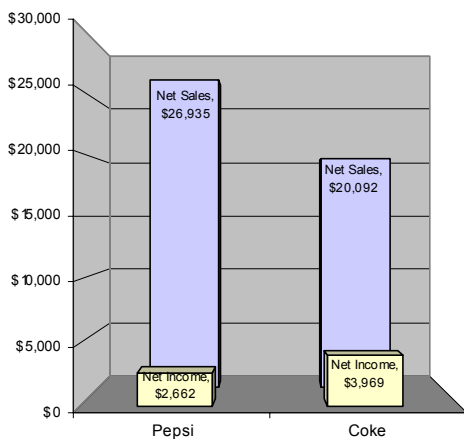
In comparison, Coke's net income is \$3,969 million, and as opposed to Pepsi's product diversification, the major source of revenue for Coke are Coca-Cola concentrate and syrups which are sold to bottlers, canners, fountain wholesalers and fountain retailers. An additional gain for Coke includes gain on issuances of stock by equity investors. Similar to Pepsi, major expenses for Coke include selling, administrative and general expenses (57.9% of total expenses) and cost of goods sold (40.2% of total expenses).[‡] These expenses are the same line items as Pepsi's, with the exception of Pepsi's merger-related costs.

Supplementary comparison points regarding the income statement are computations of the gross profit percentage, profit margin, and return on total assets[†].

	Gross Profit Percentage	Profit Margin	Return on Total Assets
Pepsi	60%	9.9%	12.3%
Coke	70%	19.8%	17.7%

Pepsi's costs to produce and deliver its products are higher than those of Coke, meaning Pepsi's gross profit is comparably less for each dollar of product sold. Further, Coke's higher profit margin, suggests that Coke is either controlling their expenses better or selling their products at a higher percentage of its cost. Based on the computation of return on total assets, Coke is better able to capitalize on its assets. However, Pepsi's apparent inefficiency may be the result of Pepsi's diverse product mix when compared to Coke.

Net Income vs. Net Sales (in millions)



Return on total assets (Pepsi) = $\$2,662\text{M} / \$21,695\text{M} = 12.3\%$
 Return on total assets (Coke) = $\$3,969\text{M} / \$22,417 = 17.7\%$

[‡] Computed: Net sales comparison = $(\$26,935\text{M} - \$20,092\text{M}) / \$20,092 = 34\%$
 Net income comparison = $(\$2,662\text{M} - \$3,969\text{M}) / \$3,969\text{M} = -0.33\%$

While Pepsi has higher net sales than Coke (by 34%), by the time that expenses are subtracted to result in net income, Pepsi is slightly lower than Coke (by -0.33%).[‡] This may be primarily a result of the costs Pepsi incurred related to its merger with Quaker. These expenses included restructuring, factory

expenses = $\$8,696\text{M} / \$15,029\text{M} = 57.9\%$

gross profit = $(\$26,935\text{M} - \$10,754\text{M}) / \$26,935\text{M} = 60\%$
 gross profit = $\$14,048\text{M} / \$20,092\text{M} = 70\%$

upgrades, severances and legal fees. However, these costs are not expected to be repeated next year. With the exception of these expenses, Pepsi's income statement appears to be reflective of current and future financial activity. Pepsi is reinvesting their profits back into the company. Unfortunately, it is difficult to value Pepsi's reinvestment in itself. This reflects a substantial flaw in the income statement, as it provides information on revenues and expenses only for the current year and does not show how investments result in future revenues and expenses. However, this flaw is a product of GAAP's reporting and not a direct result of Pepsi's reporting. Pepsi's income statement appears to be presented accurately and comparable to Coke's reporting.

Overview of the Cash Flow Statement

Both Pepsi and Coke use the indirect method to report cash flow activity. We will examine the major inflows and outflows for operational activities, investing activities, and financing activities for each company, as well as additional observations.

Major inflows for Pepsi, operationally, include:

1. Net income
2. Depreciation adjustment
3. Merger adjustment

Additional inflows for Pepsi include: Short-term investments over three months (maturities), which are included as investing activities, and short-term borrowings over three months (proceeds), which are included as financial activities.

Major outflows for Pepsi, operationally, include:

1. Cash payments for merger-related costs and restructuring
2. Accounts payable and other current liabilities

Additional outflows for Pepsi include: Short-term investments over three months (purchases), which are included as investing activities; capital spending, which is included as an investing activity; acquisitions and investments in unconsolidated affiliates, which is also an investing activity; re-purchases of common stock, a financing activity; and cash dividends paid, which is also a financing activity.

For Coke, major inflows on the operating side include:

1. Net income (\$3,969 million)
2. Depreciation adjustment

Additional inflows for Coke include: Proceeds from disposals of investments and other assets, an investing activity, and issuances of debt, which is a financing activity.

Major outflows for Coke, operationally, include:

1. Net change in operating assets and liabilities; and
2. Gains on issuances of stock by equity investees.

Additional outflows for Coke include: Purchases of property, plant, and equipment, an investing activity; acquisitions and investments of trademarks and bottling companies, also an investing activity; payments of debt, a financing activity; and dividends, a financing activity.

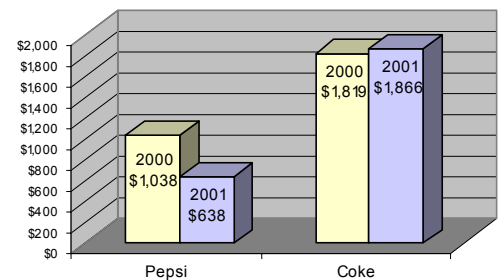
While both have a positive cash flow for the year, Coke experienced a slight net gain from 2000 to 2001 of 2.6%. In comparison, Pepsi experienced a net loss of -34%.*

Pepsi's fluctuation is primarily due to a large use of cash (outflows) in investing activities. For example:

- Pepsi made no sales of plant, property, and equipment in 2001, which was an inflow in both 1999 and 2000; and
- Pepsi experienced high outflows for acquisitions and investments in 2001 compared to 2000.

The differences between Coke and Pepsi, as has been discussed already, are primarily due to Pepsi's merger with Quaker and the associated inflows and outflows. Even though Pepsi has higher sales than Coke, Coke is currently able to control its expenses more effectively and therefore increase their margin.

**Cash Flow Trends, 2000-01
(in millions)**



Audit Report

Pepsi is audited by KPMG and Coke is audited by Ernst & Young. Both issued clean opinions and verified that the two companies are reporting in accordance with GAAP. Because of the reputation of both KPMG and Ernst & Young, we feel guardedly comfortable relying on their opinions. We have added the conditionality (“guarded”) because of recent occurrences with other independent audit firms, but have no reason to assume that Pepsi or Coke were affected.

Revenue Recognition and Receivables Valuation

Pepsi's revenue streams are more diverse in comparison to Coke. Pepsi's major product lines include PepsiCo Beverages International, Frito-Lay North America, Frito-Lay International, Pepsi-Cola North America, Gatorade/Tropicana and Quaker Foods North America. Contrary to Pepsi's product diversification, Coke's

* Computed: Coke = $(\$1,866\text{M in } 2001 - \$1,819\text{M in } 2000) / \$1,819\text{M} = 2.6\%$
Pepsi = $(\$683\text{M in } 2001 - \$1,083\text{M in } 2000) / \$1,083\text{M} = -34\%$

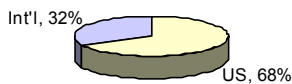
primary source of revenue is simply Coca-Cola, including the concentrates and syrups sold to bottlers, canners, fountain wholesalers and fountain retailers. In addition, Pepsi and Coke's revenue recognition both occur when the transaction is complete. More specifically, Pepsi recognizes when the product is delivered and is consistent with sales returns. Coke records the revenue when the title passes to their bottling partners or customers. Pepsi's recognition practices appear appropriate and in conformity with industry standards.

Listed below are the sales, accounts receivables, accounts receivables as a percent of current assets, accounts receivables as percent of total assets and allowance of gross accounts receivables for 2000 and 2001 for both companies.

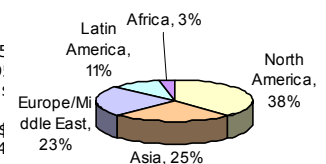
	2001	2000	% Change
Sales			
Pepsi	\$26,935 million	\$25,479 million	5.7% increase
Coke	\$20,092 million	\$19,899 million	1% increase
Accounts Receivable (AR)			
Pepsi	\$2,142 million	\$2,129 million	0.6% increase
Coke	\$1,882 million	\$1,757 million	7.1% increase
AR as % of Current Assets			
Pepsi	37%	38%	
Coke	26.2%	26.5%	
AR as % of Total Assets			
Pepsi	9.8%	10%	
Coke	8.4%	8.4%	
Allowance as % of Gross AR			
Pepsi	5.3%	5.6%	
Coke	0.26%	0.3%	

Based on the table above, we can see that Pepsi had a significant increase in sales due to the adjustments related to their merger with Quaker. Further, Pepsi's accounts receivable is comparably larger than Coke's as a percent of current and total assets. This condition may be the result of Pepsi's less stringent policies for extending credit. The discrepancies in allowances between Pepsi and Coke could be a result of several factors: (1) Pepsi could be more

Worldwide Net Sales, Pepsi



Worldwide Net Oper. Revenue, Coke



* Computed: % change in sales (Pepsi 2000-2001) = $(\$26,935M - \$25,479M) / \$25,479M = 5.7\%$
 AR % of current assets (Pepsi 2000) = $\$2129M / \$5853 = 38\%$; AR % of current assets (Pepsi 2001) = $\$2142M / \$5853 = 37\%$
 AR % of total assets (Pepsi 2000) = $\$2129M / \$21,695 = 10\%$; AR % of total assets (Pepsi 2001) = $\$2142M / \$21,695 = 10\%$
 Allowance % of gross AR (Pepsi 2000) = $\$126M / \$2255M = 5.6\%$; Allowance % of gross AR (Pepsi 2001) = $\$121M / \$2255M = 5.3\%$
 % change in sales (Coke 2000-2001) = $(\$20,092M - \$19,889M) / \$19,889M = 1\%$
 AR % of current assets (Coke 2000) = $\$1757M / \$6620M = 26.5\%$; AR % of current assets (Coke 2001) = $\$1882M / \$6620M = 28.4\%$
 AR % of total assets (Coke 2000) = $\$1757M / \$20,834M = 8.4\%$; AR % of total assets (Coke 2001) = $\$1882M / \$22,400M = 8.4\%$
 Allowance % of gross AR (Coke 2000) = $\$62M / \$20,834M = .297\%$; Allowance % of gross AR (Coke 2001) = $\$59M / \$22,400M = .26\%$



conservative by rating their accounts receivable as possible bad debt; (2) Pepsi may have riskier receivables; or (3) Pepsi's receivables may be older and less likely to be paid.

From a transaction perspective, Coke is more geographically diversified. Pepsi is more heavily concentrated in the US whereas Coke is more evenly distributed internationally, as displayed in the graphs on this page.

Based on our review of the financial statements, it does not appear that either company has material deferred revenue. Furthermore, from our understanding of this industry we can conclude that Pepsi and Coke each have contractual exclusive relationships with partners such as sports arenas and universities. When reviewing Pepsi and Coke's business practices, there is nothing that alerts us to a risk of misstatements. In light of these arrangements, Pepsi's financial statements appear properly stated.

Cost of Goods Sold and Inventory Valuation

Pepsi and Coke's major inventories fall within the category of raw materials, works in progress, finished goods and supplies. Each predominately uses the first-in-first-out method of inventory valuation. Pepsi also uses last-in-last-out for 20% of its inventory valuation, but reports that this is not material to its inventory reports. Additionally, Coke acknowledges that it occasionally uses average valuation methods.

To contribute to further understanding, we computed and graphed the following:

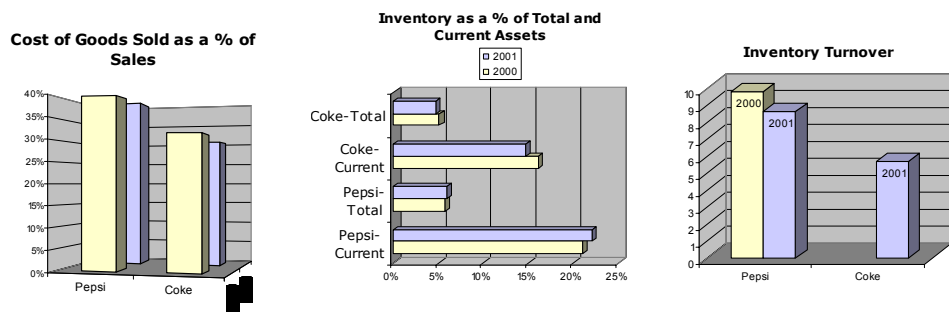
	2000	2001
Cost of Goods Sold as a Percent of Sales		
Pepsi	40.1%	39.9%
Coke	31.2%	30.1%
Inventory as a Percent of Current Assets		
Pepsi	21%	22%
Coke	16.1%	14.7%
Inventory as a Percent of Total Assets		
Pepsi	5.7%	6%
Coke	5.1%	4.7%
Inventory Turnover Ratio		
Pepsi	9.78	8.6
Coke	Not enough information provided	5.7

* Computed: COGS as % of sales (Pepsi 2000) = \$10,226M / \$25,479M = 40.1%; (Pepsi 2001) = \$10,754M / \$26,935M = 39.9%
 COGS as % of sales (Coke 2000) = \$6,204M / \$19,889M = 31.2%; (Coke 2001) = \$6,044M / \$20,092M = 30.1%
 Inventory as % of current assets (Pepsi 2000) = \$1,192M / \$5,617M = 21%; (Pepsi 2001) = \$1,310M / \$5,853M = 22%
 Inventory as % of current assets (Coke 2000) = \$1,066M / \$6,630M = 16.1%; (Coke 2001) = \$1,055M / \$7,171M = 14.7%
 Inventory as % of total assets (Pepsi 2000) = \$1,192M / \$20,757M = 5.7%; (Pepsi 2001) = \$1,310M / \$21,695M = 6%
 Inventory as % of total assets (Coke 2000) = \$1,192M / \$20,834M = 5.1%; (Coke 2000) = \$1,310M / \$22,417M = 4.7%
 Inventory turnover ratio (Pepsi 2000) = \$10,226M / (average inventory 1999-00) = 9.78; (Pepsi 2001) = \$10,754M / (average inventory 2000-01) = 8.6
 Inventory turnover ratio (Coke 2000) ... no data available for 1999 inventories, so average inventory cannot be computed, and therefore inventory turnover cannot be computed; (Coke 2001) = \$6,044M / (average inventory 2000-01) = 5.7

These figures suggest that Coke is operationally better than. It costs less to make Coke than it does to make Pepsi, which may be due to the variety of products sold by Pepsi. Further, we can see that Pepsi maintains a comparably larger inventory balance as a percent of current and total assets. This larger balance could suggest a financial risk, however, the risk of not excessive as Pepsi has a higher turnover rate.

Currently, neither Pepsi nor Coke has any inventory writedowns in their financial statements. Past inventory writedowns may have included such “failed” products as Crystal Pepsi and New Coke. In the future, writedowns may be recorded for products such as: Code Red Mountain Dew, Blue Raspberry Pepsi, Vanilla Coke and Lemon Coke. Only consumers will determine if these products will result in inventory writedowns.

Inventory valuation risks, as reported by Pepsi, include market risk with respect to commodities. Coke discloses that its primary valuation risk is in respect to adverse movements in foreign currency or interest rates,



which makes sense

because of the large amount Coke’s geographic diversification.

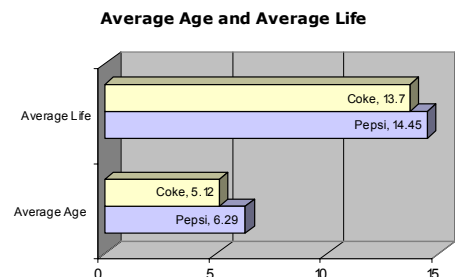
Overall, Pepsi’s reported inventory appears reasonable and their valuation techniques conform with industry standards.

Property, Plant, and Equipment

We will now turn to a discussion of Pepsi’s property, plant, and equipment and associated depreciation, as compared to Coke. Both Pepsi and Coke report the same two major elements of property, plant, and equipment (PPE):

1. Machinery and equipment
2. Buildings and improvements

This makes sense for both companies, because, in order to manufacture, bottle, and distribute their products, they need





machinery, equipment, and buildings. For Pepsi, the total PPE (less depreciation) is 31.7% of total assets. Coke's PPE (less depreciation) amounts to 19.9% of total assets.^{*} This difference may be due to the fact that, while Coke manufactures only beverages, Pepsi manufactures food products under its Frito-Lay and Quaker brands. This requires additional machinery and equipment that Coke does not need for its operations.

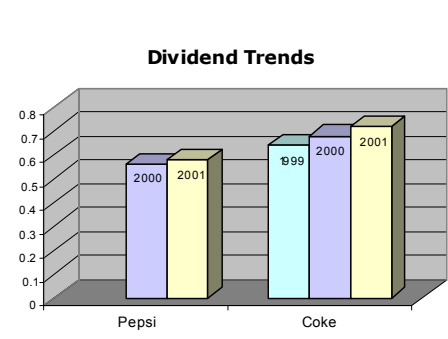
During the year, both Pepsi and Coke invested in additional PPE. Coke also realized proceeds from disposals of PPE in the same period, whereas Pepsi reported no sales of PPE.

The average age of Pepsi's PPE is 6.29 years. Coke's average age is 5.12 years. The estimated life of Pepsi's PPE is 14.45 years. Coke's estimated life is 13.7 years.[†] In this instance, Pepsi and Coke are comparable to one another. Neither company appears to have PPE that is excessively old (likely to be close to disposal).

Both use straight-line depreciation over useful life. Because they use the same method, and this is the most widely-accepted method under GAAP, this is a reasonable and reliable depreciation method.

Stockholders Equity

Pepsi's equity includes both preferred and common stock, as well as retained earnings, deferred compensation, and repurchased common stock (treasury stock). Coke's includes common stock and treasury stock, as well as reinvested earnings. Just as it has affected so many other material aspects of Pepsi's financials, Pepsi's merger with Quaker significantly affects their stockholders equity. In fact, Pepsi issued 3.2 shares of PepsiCo stock in exchange for every share of Quaker stock outstanding. This resulted in an increase of 306 million additional common shares on the market.



With regard to declared dividends, shareholders with both companies have seen an increase in 2001. In 1999, Coke shareholders saw a dividend of \$0.64 per share, which increased to \$0.68 in 2000 and to \$0.72 in 2001. Pepsi common stock shareholders saw a dividend of \$0.56 per share in 2000, which

* Computed: Pepsi = \$6,876M net PPE / \$21,695 M total assets = 31.7%
 Coke = \$4,453M net PPE / \$22,417M total assets = 19.9%

† Computed: Pepsi average age = \$5,304M accumulated depreciation / \$843M annual depreciation expense = 6.29
 Pepsi estimated life = (\$12,180M PPE cost - \$0 residual value assumed) / \$843M annual depreciation expense = 14.45
 Coke average age = \$2,652M accumulated depreciation / \$518M annual depreciation expense = 5.12
 Coke estimated life = (\$7,105M PPE cost - \$0 residual value assumed) / \$518M depreciation expense = 13.7



increased to \$0.58 in 2001^{*}. Pepsi's preferred stock dividends remained steady, at \$4 million for 1999, 2000, and 2001.

Pepsi reports basic earnings per share (EPS) of \$1.51 and a diluted EPS of \$1.47. At year end 2001, Pepsi had outstanding stock options of 176,922,000, of which 83,521,000 were exercisable. Due to the existence of these stock options, Pepsi has reported a dilutive effect of \$0.04 per share (\$1.51-\$1.47). According to Pepsi's footnotes, compensation expense is not recorded for stock-based awards. If these stock options, as compensation, were recorded in the income statement, net income would be reduced by \$306,000. In comparison, Coke reports the same figure for both basic and diluted EPS, \$1.60, and records virtually no dilutive effect of stock options for 2001.

While we feel that Pepsi's management has provided adequate information in this area, we do recommend using an amended net income figure, taking into account the additional compensation of stock options. Stock option costs are essentially a cost of doing business, as are all other forms of employee compensation, as a means of retaining high-performing employees. Since other methods of compensation are included to calculate net income, stock option figures should be as well. Users should be presented with all available information in order to have a more accurate reflection of Pepsi's earnings. It is interesting to note that Coke has elected to convert to the "fair value method" for disclosing its stock options in 2002. It has yet to be seen has this will affect Coke's financials.

Unusual/Non-recurring Items

Coke's business and operations are stable, consistent and relatively unchanged. They are largely operating under business-as-usual conditions. Pepsi, however, has recently experienced a major merger with Quaker, and this has led to a number of unusual items throughout their annual report, including the income statement. In fact, the income statement includes a line item for merger-related costs; included in those costs were consulting fees, expenses for accelerated vesting, employee separation packages and information system integration costs. Most of the items should not reoccur after 2003, except for some additional integration costs. Pepsi's net income with merger-related costs and restructuring charges (to upgrade Quaker's manufacturing and distribution capabilities), as it is currently reported, is \$2,662 million. Without the merger-related costs or

* Computed: While Coke's total dividend per share is provided in their financials for 1999-2001, for Pepsi's, we were provided with per quarter data, and added it together: Dividends in 2001 = .14+.145+.145+.145; Dividends in 2000 = .135+.14+.14+.14



restructuring costs, net income would amount to \$3,049 million*. After analysis, we feel more comfortable relying on the net income with the merger-related costs factored in, because this merger will be a significant future revenue generator for Pepsi.

While Coke does include a footnote disclosing nonrecurring items (footnote 15), there are no material items that will affect their comparison with Pepsi in the future.

Conclusion

In summary, the major financial aspects we have discovered about Pepsi include:

- Pepsi has a large amount of product diversification when compared to their major competitor, resulting in higher net sales and higher equipment (PPE) totals;
- A significant portion of Pepsi's assets are intangibles (70% related to the Quaker merger), amortization related to these intangibles will continue to affect Pepsi's earnings over the next few year. Additionally, Pepsi's financial comparability to Coke may change as these assets are amortized;
- While Pepsi has higher net sales than that of its major competitor, its net income is lower, meaning it has more expenses, which will need to be controlled to ensure future profitability;
- Pepsi's cash flow, while still netting positive for 2001, decreased significantly (by over one-third) from 2000. This should be a major concern for G. D. Meyers and Company on a go-forward basis, if Pepsi is unable to get control over this area of their operations;
- Pepsi experiences a high inventory turnover compared to Coke, requiring them to maintain higher inventories, which (once expenses are better controlled) may bode well for Pepsi's financial future; and
- Pepsi's 2001 merger with Quaker Oats has affected 2001 financials due to additional expenses, cash flows, stock dilution and goodwill; however, it will hopefully position them for future growth.

Based on our observations and analysis, we can conclude that Pepsi utilizes viable accounting policies and is taking steps to ensure future profitability. This leads us to suggest that G. D. Meyers and Company can feel secure about underwriting an additional issue of stock, although future analysis in part II will confirm these observations.

* Computed: \$2,662M net income + \$356M merger-related costs + \$31M other impairment and restructuring costs = \$3,049 M