

Exhibit 6 (continued) Instructions for Preparation of Form NY 1292-C Financial Evaluation

This form is to be submitted to Corporate Budget and Analysis with each profit-increasing capital project request requiring \$50,000 or more of capital funds and expense before taxes.

Note that the 10-year term has been divided into 11 periods. The first period is to end on the March 31 following the operational date of the project, and the P&L projection may thereby encompass any number of months from 1 to 12, e.g., if the project becomes operational on November 1, 1964, the first period for P&L purposes would be 5 months (November 1, 1964 through March 31, 1965). The next nine periods would be fiscal years (F '66, F '67, etc.) and the 11th period would be 7 months (April 1, 1974 through October 30, 1974). This has been done primarily to facilitate reporting of projected and actual P&L data by providing for fiscal years. See categorized instructions below for more specific details.

Project Request Detail Lines 1 through 11 show the breakdown of the Net Project Cost to be used in the financial evaluation. Line 8 is to show the amount expected to be realized on trade-in or sale of a replaced asset. Line 9 should be the same as the "Total Project Cost" shown on Form NY 1292-A, Capital Project Request. Space has been provided for capital expenditures related to this project which are projected to take place subsequent to the first period. Indicate in such space the additional cost only; do not accumulate them.

Funds Employed

Capital Funds Employed Line 12 will show the net project cost appearing on line 11 as a constant for the first 10 periods except in any period in which additional expenditures are incurred; in that event show the accumulated amount of line 11 in such period and in all future periods.

Deduct cumulative depreciation on Line 13. Depreciation is to be computed on an incremental basis, i.e., the net increase in depreciation over present depreciation on assets being replaced. In the first period depreciation will be computed at one half of the first year's annual rate; no depreciation is to be taken in the 11th period. Depreciation rates are to be the same as those used for accounting purposes. *Exception:* When the depreciation rate used for accounting purposes differs materially from the rate for tax purposes, the higher rate should be used. A variation will be considered material when the first full year's depreciation on a book basis varies 20% or more from the first full year's depreciation on a tax basis.

The 10-year average of Capital Funds Employed shall be computed by adding line 14 in each of the first 10 periods and then dividing the total by 10.

Total Working Funds Refer to Financial Policy No. 21 as a guide in computing new working fund requirements. Items which are not on a formula basis and which are normally computed on a five-quarter average shall be handled proportionately in the first period. For example, since the period involved may be less than 12 months, the average would be computed on the number of quarters involved. Generally, the balances should be approximately the same as they would be if the first period were a full year.

Cash, based on a formula which theorizes a two weeks' supply (2/52nds), should follow the same theory. If the first period is for three months, two-thirteenths (2/13th) should be used; if it is for five months, two-twenty-firsts (2/21sts) should be used, and so forth.

The Super Project

112-034

Exhibit 6 (continued)

Current liabilities are to include one-half of the tax expense as the tax liability. The 10-year averages of Working Funds shall be computed by adding each line across for the first 10 periods and then dividing each total by 10.

Profit and Loss Projection

P&L Categories (Lines 22 through 37) Reflect only the incremental amounts which will result from the proposed project; exclude all allocated charges. Include the P&L results expected in the individual periods comprising the first 10 years of the life of the project. Refer to the second paragraph of these instructions regarding the fractional years' calculations during the first and eleventh periods.

Any loss or gain on the sale of a replaced asset (see line 8) shall be included on line 33.

As indicated in the caption Capital Funds Employed, no depreciation is to be taken in the eleventh period.

The 10-year averages of the P&L items shall be computed by adding each line across for the 10 periods (10 full years from the operational date) and dividing the total by 10.

Adjustments (Line 34) Show the adjustment necessary, on a before-tax basis, to indicate any adverse or favorable incremental effect the proposed project will have on any other products currently being produced by the corporation.

Investment Credit To be included on line 36-A. The Investment Credit will be spread over 8 years, or fractions thereof, as an addition to PAT.

Return on New Funds Employed Ten-year average returns are to be calculated for PAT (projects requiring Board approval only) and PBT. The PAT return is calculated by dividing average PAT (line 37) by average new funds employed (line 21); the PBT return is derived by dividing average PBT (line 35) by average new funds employed (line 21).

Payback Years From Operational Date

Part Year Calculation for First Period Divide number of months in the first period by 12. If five months are involved, the calculation is $5/12 = 0.4$ years.

Number of Full Years to Payback Determined by the last period, excluding the first period, in which an amount is shown on line 39.

Part Year Calculation for Last Period Divide amount still to be repaid at the end of the last full period (line 39) by net profit plus the annual depreciation in the following year when payback is completed.

Total Years to Payback Sum of full and part years.

Appendix A Memos to Controller

To: J. C. Kresslin, Corporate Controller
From: J. E. Hooting, Director, Corporate Budgets and Analysis
March 2, 1967

Super Project

At the time we reviewed the Super project, I indicated to you that the return on investment looked significantly different if an allocation of the agglomerator and building, originally justified as a Jell-O project, were included in the Super investment. The pro rata allocation of these facilities, based on the share of capacity used, triples the initial gross investment in Super facilities from \$200,000 to about \$672,000.

I am forwarding a memorandum from Crosby Sanberg summarizing the results of three analyses evaluating the project on an:

- I. Incremental basis
- II. Facilities-used basis
- III. Fully allocated facilities and costs basis

Crosby has calculated a 10-year average ROFE using these techniques. Please read Crosby's memo before continuing with my note.

* * * * *

Crosby concludes that the fully allocated basis, or some variation of it, is necessary to understand the long-range potential of the project:.....

I agree. We launch a new project because of its potential to increase our sales and earning power for many years into the future. We must be mindful of short-term consequences, as indicated by an incremental analysis, but we must also have a long-range frame of reference if we are to really understand what we are committing ourselves to. This long-range frame of reference is best approximated by looking at fully allocated investment and "accounted" profits, which recognize fully allocated costs because, in fact, over the long run all costs are variable unless some major change occurs in the structure of the business.

Our current GF preoccupation with only the incremental costs and investment causes some real anomalies that confuse our decision making. Super is a good example. On an incremental basis the project looks particularly attractive because by using a share of the excess capacity built on the coattails of the lucrative Jell-O project, the incremental investment in Super is low. If the excess Jell-O capacity did not exist, would the project be any less attractive? In the short term, perhaps yes because it would entail higher initial risk, but in the long term it is not a better project just because it fits a facility that is temporarily unused.

Looking at this point from a different angle, if the project exceeded our investment hurdle rate on a short-term basis but fell below it on a long-term basis (and Super comes close to doing this), should we reject the project? I say yes because over the long run, as "fixed" costs become variable and as we have to commit new capital to support the business, the continuing ROFE will go under water.

In sum, we have to look at new project proposals from both the long-range and the short-term point of view. We plan to refine our techniques of using a fully allocated basis as a long-term point of reference and will hammer out a policy recommendation for your consideration. We would appreciate any comments you may have.

The Super Project

112-034

Appendix A (continued) Memos to Controller

To: J. E. Hooting, Director, Corporate Budgets and Analysis

From: C. Sanberg, Manager, Financial Analysis

February 17, 1967

Super Project: A Case Example of Investment Evaluation Techniques

This will review the merits of alternative techniques of evaluating capital investment decisions using the Super project as an example. The purpose of the review is to provide an illustration of the problems and limitations inherent in using incremental ROFE and payback and thereby provide a rationale for adopting new techniques.

Alternative Techniques

The alternative techniques to be reviewed are differentiated by the level of revenue and investment charged to the Super project in figuring a payback and ROFE, starting with incremental revenues and investment. Data related to the alternative techniques outlined below are summarized [at the end of this memo].

Alternative I. Incremental Basis

Method The Super project as originally evaluated considered only incremental revenue and investment, which could be directly identified with the decision to produce Super. Incremental fixed capital (\$200M) basically included packaging equipment.

Result On this basis the project paid back in 7 years with a ROFE of 63%.

Discussion Although it is General Foods' current policy to evaluate capital projects on an incremental basis, this technique does not apply to the Super project. The reason is that Super extensively utilizes existing facilities, which are readily adaptable to known future alternative uses.

Super should be charged with the 'opportunity loss' of agglomerating capacity and building space. Because of Super the opportunity is lost to use a portion of agglomerating capacity for Jell-O and other products that could potentially be agglomerated. In addition, the opportunity is lost to use the building space for existing or new product volume expansion. To the extent there is an opportunity loss of existing facilities, new facilities must be built to accommodate future expansion. In other words, because the business is expanding Super utilizes facilities that are adaptable to predictable alternative uses.

Alternative II. Facilities-Used Basis

Method Recognizing that Super will use half of an existing agglomerator and two-thirds of an existing building, which were justified earlier in the Jell-O project, we added Super's pro rata share of these facilities (\$453M) to the incremental capital. Overhead costs directly related to these existing facilities were also subtracted from incremental revenue on a shared basis.

Result ROFE 34%

Discussion Although the existing facilities utilized by Super are not incremental to this project, they are relevant to the evaluation of the project because potentially they can be put to alternative uses. Despite a high return on an incremental basis, if the ROFE on a project was unattractive after consideration of the shared use of existing facilities, the project would be questionable. Under these circumstances, we might look for a more profitable product for the facilities.

In summary, the facilities-used basis is a useful way of putting various projects on a common ground for purposes of relative evaluation. One product using existing capacity should not necessarily be judged to be more attractive than another practically identical product which necessitates an investment in additional facilities.

Alternative III. Fully Allocated Basis

Method Further recognizing that individual decisions to expand inevitably add to a higher overhead base, we increased the costs and investment base developed in Alternative II by a provision for overhead expenses and overhead capital. These increases were made in year five of the 10-year evaluation period, on the theory that at this point a number of decisions would result in more fixed costs and facilities. Overhead expenses included manufacturing costs, plus selling and general and administrative costs on a per unit basis equivalent to Jell-O. Overhead capital included a share of the distribution system assets (\$40M).

Result ROFE 25%

Discussion Charging Super with an overhead burden recognizes that overhead costs in the long run increase in proportion to the level of business activity, even though decisions to spend more overhead dollars are made separately from decisions to increase volume and provide the incremental facilities to support the higher volume level. To illustrate, the Division-F1968 Financial Plan budgets about a 75% increase in headquarters' overhead spending in F1968 over F1964. A contributing factor was the decision to increase the sales force by 50% to meet the demands of a growing and increasingly complex business. To further illustrate, about half the capital projects in the F1968 three-year Financial Plan are in the 'non-payback' category. This group of projects comprised largely 'overhead facilities' (warehouses, utilities, etc.), which are not directly related to the manufacture of products but are necessary components of the total business activity as a result of the cumulative effect of many decisions taken in the past.

The Super project is a significant decision which will most likely add to more overhead dollars as illustrated above. Super volume doubles the powdered dessert business category; it increases the Division businesses by 10%. Furthermore, Super requires a new production technology: agglomeration and packaging on a high-speed line.

Conclusions

1. The incremental basis for evaluating a project is an inadequate measure of a project's worth when existing facilities with a known future use will be utilized extensively.
2. A fully allocated basis of reviewing major new product proposals recognizes that overheads increase in proportion to the size and complexity of the business and provides the best long-range projection of the financial consequences.

The Super Project

112-034

Alternative Evaluations of Super Project (\$ in thousands)

	I. Incremental Basis	II. Facilities-Used Basis	III. Fully Allocated
Investment			
Working capital	\$267	\$267	\$267
Fixed capital			
Gross	200	653	672
Net	113	358	367
Total net investment	380	625	634
Profit before taxes^a	239	211	157
ROFE	63%	34%	25%
Jell-O project			
Building	$\$200 \times 2/3 =$	\$133	
Agglomerator	$640 \times 1/2 =$	320	
		\$453	

Note: Figures based on 10-year averages.

^aAssumes 20% of Super volume will replace existing Jell-O business.

112-034

The Super Project

Appendix B Controller's Reply

To: Mr. J. F. Hooting, Director, Corporate Budgets and Analysis
From: Mr. J. C. Kresslin, Corporate Controller
Subject: Super Project
March 7, 1967

On March 2 you sent me a note describing Crosby Sanberg's and your thoughts about evaluating the Super project. In this memo you suggest that the project should be appraised on the basis of fully allocated facilities and production costs.

In order to continue the dialogue, I am raising a couple of questions below.

It seems to me that in a situation such as you describe for Super, the real question is a *management decision* as to whether to go ahead with the Super project or not go ahead. Or to put it another way, are we better off in the aggregate if we use half the agglomerator and two-thirds of an existing building for Super, or are we not, on the basis of our current knowledge?

It might be assumed that, for example, half of the agglomerator is being used and half is not and that a minimum economical size agglomerator was necessary for Jell-O and, consequently, should be justified by the Jell-O project itself. If we find a way to utilize it sooner by producing Super on it, aren't we better off in the aggregate, and the different ROFE figure for the Super project by itself becomes somewhat irrelevant? A similar point of view might be applied to the portion of the building. Or if we charge the Super project with half an agglomerator and two-thirds of an existing building, should we then go back and relieve the Jell-O projects of these costs in evaluating the management's original proposal?

To put it another way, since we are faced with making decisions at a certain time on the basis of what we then know, I see very little value in looking at the Super project all by itself. Better we should look at the total situation before and after to see how we fare.

As to allocated production costs, the point is not so clear. Undoubtedly, over the long haul, the selling prices will need to be determined on the basis of a satisfactory margin over fully allocated costs. Perhaps this should be an additional requirement in the course of evaluating capital projects, since we seem to have been surprised at the low margins for "Tasty" after allocating all costs to the product.

I look forward to discussing this subject with you and with Crosby at some length.