

## Example of Direct vs. Indirect Method V

- Sell PPE worth \$70 on books for \$75 cash
- Gain of \$5 goes on income statement
- But all \$75 of cash is considered Investing

	Net Income	Direct SCF		Indirect SCF	
Sales: \$100 cash	100	Collect from cust	100	Net Income	35
COGS: \$60 all cash	(60)	Pay to suppliers	(60)	Add Deprec. Exp	10
Depreciation: \$10	(10)			Less Gain	(5)
Gain on sale of PPE: \$5	5				
Net Income	35	Operating CF	40	Operating CF	40
Sale of PPE: \$75		Proceeds from sale	75	Proceeds from sale	75
		Investing CF	75	Investing CF	75

## SCF Complications

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- **Why does the change in balance sheet numbers often not equal the number on the SCF?**
- **Noncash investing and financing activities**
  - Supplemental disclosure below SCF
- **Acquisitions and divestitures of businesses**
  - Investing activity that affects balances in operating asset and liability accounts
- **Foreign Currency Translation Adjustments**
  - Changes in cash due to exchange rate movements shown separately
- **Subsidiaries in different industries (e.g. real estate)**
  - Some transactions (e.g. buying land) are investing activities in one part of business and operating in another

## Disagreement over FASB Classification

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- **Many investors and analysts prefer to classify**
  - **Interest payments as a financing activity**
    - Cash paid for interest must be disclosed
  - **Interest and dividends received as an investment activity**
- **All income tax effects are shown in the operating section, even if the income relates to financing or investing activities**
  - **Cash taxes must be disclosed**

## EBITDA, Earnings, and Cash Flows

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- **EBITDA (Earnings before interest, taxes, depreciation, and amortization) is often used as a proxy for cash flow that excludes interest and taxes**
  - However, EBITDA does not measure cash flow well if there are large changes in working capital and suffers from the same manipulation potential as net income
  - For example, “channel stuffing” would increase earnings and EBITDA, but no cash is collected (instead, accounts receivable increase). Subtracting the increase in AR from EBITDA would correct this problem
- **Research finds that Earnings are a better predictor of future cash flow than current Cash Flow from Operations**
  - But using both gives the best predictions

# Free Cash Flow

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- Operating cash flow minus cash for long-term investments
- There is no standard measure for operating cash flow. Examples for different textbooks include:
  - Cash from operations before interest expense
  - NOPLAT (Net operating profits less adjusted taxes)
    - $(\text{NOPLAT} = \text{EBITDA} - \text{Cash taxes on EBITDA})$
  - NOPAT – increase in working capital
    - $(\text{NOPAT} = \text{Net Income} + \text{After-tax net interest expense})$
  - Net income adjusted for depreciation and other noncash items – increase in working capital
  - $\text{EBIT}(1 - \text{tax rate}) + \text{Depreciation}$
  - EBITDA
- Companies often disclose free cash flow using their own custom definition