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

Wharton
University of Pennsylvania

SCF Complications

- 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

- **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

- **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

- 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)
    - (NOPLAT = EBITDA – Cash taxes on EBITDA)
  - NOPAT – increase in working capital
    - (NOPAT = Net Income + After-tax net interest expense)
  - Net income adjusted for depreciation and other noncash items – increase in working capital
  - EBIT(1-tax rate) + Depreciation
  - EBITDA
- Companies often disclose free cash flow using their own custom definition