

CASH FLOW FROM OPERATIONS- DO WE NEED ANY OTHER CASH FLOW TERMS?

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Jim Hines, controller, was facing a dilemma. The president of the firm asked him to consider adding two pro forma, or non-GAAP, accounting terms to all financial releases and reports. The terms were EBITDA and free cash flow. As an accountant Jim was satisfied with the GAAP reporting, and he did not see a need to add non-GAAP terms to all reports.

He had to research the recent requirements on pro forma reporting from the Sarbanes-Oxley Act. If a firm used pro forma terms, the firm had to reconcile the term to a directly comparable GAAP term, and explain why the term should be useful to investors.

Jim is at the point of writing a report to the president, but he is unsure of the tone of the report, since he knows the president favors pro forma reporting.

The case is intended for an undergraduate or graduate course in financial statement analysis. The case sets the scene where a non-accountant president is interested in adding non-GAAP terms to the financial reports. At the end of the case, the student must make a choice to add or not to add pro forma terms to the GAAP reports. Two widely used pro forma accounting terms, EBITDA and free cash flow, are defined and compared to the GAAP term, cash flow from operations. The student must calculate the terms from the company's financial statements and compare them to cash flow from operations. The basic reporting requirements for the use of pro forma terms under the Sarbanes-Oxley Act are introduced.

The case has a growth and a contraction scenario for the firm, and with the application of three cash flow terms, the student should see the vivid difference between cash and accrual accounting. The student should see the imprudence of attempting to use one summary number for a cash flow number, whether it be cash flow from operations, EBITDA, or free cash flow. The need to analyze the three components of the cash flow statement (operations, investing and financing activities) becomes evident from this case.

It was late Monday morning and Jim Hines was returning to his office after a typical Monday Management meeting. These meetings tended to either very exciting or very boring. Today's meeting was boring, but after the meeting, Lou Silas, president of the firm called Jim aside and asked him to lunch. Mr. Silas left him with the promise "I have some amazing accounting improvements to show you!"

Jim was baffled with Mr. Silas's sudden interest in accounting. Within the firm Mr. Silas was known as a superior salesman and he felt most comfortable with the sales and marketing staffs. It was also widely known he was not nearly as comfortable with the accounting and finance staff. He felt accountants were too reserved and rigid in approaching new business prospects. Recently Mr. Silas had used the internet for much of his Christmas shopping. After selecting various items for his family, Mr. Silas clicked on the financial statements for some of these internet retailers. He was very impressed with the level of detail in the quarterly reports and the use of new accounting terms. Two of these new terms were earnings before interest, taxes, depreciation, and amortization(EBITDA) and free cash flow.

Mr. Silas assured Jim that the accounting department served the firm well through all the reports it issued. But he thought it might be time to add some new terms and analysis to the conventional approach that Jim had followed. Mr. Silas wanted Jim's views on the use of pro forma accounting figures, and whether the firm should include the two terms in future financial press releases, financial reports, as well as distribute the terms internally.

JIM HINES, CONTROLLER

Jim was 35 years old and controller of Meriden Products. He had joined Meriden five years ago as assistant controller after advancing through accounting positions for the prior 8 years. He had an undergrad degree in accounting, and was working toward an MBA, attending graduate school at night while working as a corporate accountant. He took pride in being a "shirtsleeve accountant"- well versed in the technical aspects of accounting. He was viewed as the accounting expert at the firm when any questions came up about accounting or changes in financial reporting. While Jim had spent years becoming proficient in the accounting fundamentals, he realized that he had to see Meriden's business more broadly than just through accounting. He wanted to expand from the conventional model of controller with debits and credits to one who goes beyond strict accounting to serving as the chief information source. But in gaining a broader business perspective, he did not believe he had to give up much of the discipline of double-entry accounting.

THE FIRM

Meriden Products was a manufacturing firm that was experiencing a three-year burst of growth from the year 2004. From the mid 1990s the firm expanded its domestic product line and customer base, and since 2004 directed its attention to sales outside the US. For 2006 the firm achieved sales of \$152 million, doubling sales over the three year period 2004-2006 (Exhibits A and B). That impressive sales growth was accompanied by an increase in receivables and inventories to service new customers and support the growth, as well as increased capital spending on cost efficient plant and equipment.

President Silas was disappointed that investment analysts and investors did not show increased interest in the firm for its profitable growth for 2004-2006. In this period portfolio managers were showing increasing interest in small cap firms, those about the size of Meriden. The president was trying to promote interest in Meriden, and he thought new accounting terms would present Meriden in a favorable light.

HINES' REPORT

Jim started his research for the president by getting definitions for the new accounting terms. EBITDA had been around for over twenty years and there was agreement on its definition: earnings before interest, taxes, depreciation, and amortization. He gave a second definition: take operating income on the income statement and add back depreciation and amortization.

EBITDA was the more widely known of the two new terms. Security analysts and portfolio managers have used it in valuing firms in certain industries, for example, the cable and entertainment industries and in valuing mergers and acquisitions. EBITDA is a cash flow term that indicates the core operating cash flow that can be dedicated to all cash demands. It purposefully leaves out interest as a financing cost, and leaves out tax expense as a non-operating line. Then by leaving out depreciation and amortization as non-cash expenses, it focuses on cash operating items.

The term originally was used in leveraged buyouts to indicate the amount of cash flow that could be used to pay down the large debt that was taken on. Frequently in leveraged buyouts, management raised cash to take the firm private by taking on large amounts of debt. From its beginning, EBITDA users staunchly believed that since goodwill amortization expense was a non-cash charge, it should be added back to operating income. These believers felt exonerated when the FASB issued FAS 142, which dropped the requirement to yearly amortize goodwill on the income statement. Now a firm would have to review the goodwill balance each year to determine if an impairment in the goodwill value had taken place.

Jim had some questions about the use of EBITDA since it left out the important negative cash flows of interest expense and income taxes, which have to be paid each year. Jim feared that by leaving out these two terms, EBITDA violated the matching principle in accounting. The expenses of interest and taxes were not matched with sales to arrive at net income.

It also disregarded the need to continually fund or finance working capital needs of accounts receivable and inventory, and the need to replace worn out capital equipment through capital spending. These were all important cash needs for a going concern entity, with the receivable and inventory changes clearly shown in cash flow from operations, and capital spending shown in investing activities on the cash flow statement. Without the replenishment of working capital and new capital spending, he thought that EBITDA disregarded the going concern assumption in accounting.

Free cash flow had several definitions used by the financial press and various investment firms. One definition was cash flow from operations less capital spending. A second, more restrictive definition was cash flow from operations less capital spending and less dividends.

Free cash flow is a somewhat more recent term, but it is used less frequently than EBITDA. Jim decided on the definition of cash flow from operations less capital spending. This term is used by security analysts and portfolio managers and is seen in the financial press. Like EBITDA, free cash flow emphasizes the core cash flow that management has a choice in using. After subtracting capital spending from cash flow from operations, management has the choice to pay dividends, pay down debt, purchase its own common stock, or make acquisitions. After a firm replaces the productive capacity that was used up or consumed in the year, it has a core amount of cash flow to dedicate to these various uses.

One problem with free cash flow occurs when a firm is expanding and in a strong growth stage, which describes Meriden in the past five years. The total capital spending represents replacement of consumed equipment and the expansion of plant and equipment through new equipment purchases. It is almost impossible to separate the amount of capital spending that represents replacement of consumed equipment from the expansion with new equipment. The purist form of free cash flow prefers to subtract capital spending for replacement of old equipment from cash flow from operations. The amount of capital spending for expansion is one of the uses of free cash flow. In Meriden's case, free cash flow is probably understated since the firm has spent so much on capital expansion in the past five years. Part of the total capital spending is for replacement and the remainder represents the choice management

made to expand.

SARBANES-OXLEY REQUIREMENTS

Many observers and regulators of the accounting profession believe that the expanded use of pro forma accounting figures contributed to the stock market bubble in the late 1990s. The passage of the Sarbanes-Oxley bill was an attempt to correct many of the perceived accounting abuses, among them, the use of pro forma figures.

Under Sarbanes-Oxley, firms that use pro forma figures must report the directly comparable GAAP (Generally Accepted Accounting Principles) number, and then reconcile the pro forma figure to the GAAP figure. Additionally, the firm must disclose why management believes the presentation of the non-GAAP financial measure provides useful information to investors concerning the firm's financial condition and results of operation, and disclose purposes for which management uses the non-GAAP measures.

Jim was concerned with the added level of disclosure required for pro forma numbers. He was not sure if the company would make a clear case for its use of pro forma data if the firm had never used them previously.

DECISION TIME

After outlining basic definitions along with the advantages and disadvantages for both pro forma figures, Jim looked at Meriden's financial statements to calculate the pro forma figures. He was not sure how to explain what additional information the pro forma figures gave beyond the GAAP numbers. Jim remembered the FASB's Conceptual Statement One, in which user needs for information were pre-eminent. To him that meant his personal views on correct accounting techniques were less important; if the users of Meriden's financial statements, such as officers of the firm and outside investors, asked for the two pro forma figures, he should comply and provide them. But he was still unsure of how to respond to Mr. Silas' request for his recommendations on the use of pro forma terms.

Jim started with the audited financial statements for year-end 2006. He also had some projections from a profit planning session held only two months ago (Exhibit C). From this planning session he took a less optimistic scenario for the firm, in which sales decrease over the next three years. Jim wanted to see if cash flow from operations or the two pro forma terms performed differently in a contraction scenario versus a growth scenario for the firm.

EXHIBIT A

Meriden Products
Income Statement
Years Ending December 31
(000)

	2004	2005	2006
Sales	\$95,000	\$119,000	\$152,000
Cost of goods sold	<u>57,000</u>	<u>70,210</u>	<u>88,160</u>
Gross profit	38,000	48,790	63,840
Selling expense	14,810	18,000	22,100
General & adm.	7,040	8,775	11,340
Operating expenses	<u>21,850</u>	<u>26,775</u>	<u>33,440</u>
Operating income	16,150	22,015	30,400
Interest expense	<u>3,464</u>	<u>4,777</u>	<u>6,931</u>
Pre-tax income	12,686	17,238	23,469
Tax expense	<u>4,440</u>	<u>6,033</u>	<u>8,214</u>
Net income	<u>8,246</u>	<u>11,205</u>	<u>15,255</u>
EPS	\$.41	\$.56	\$.76

EXHIBIT B

**Meriden Products
Statement of Cash Flows
Years Ending December 31
(000)**

	<u>2004</u>	<u>2005</u>	<u>2006</u>
<u>Cash flows from operations</u>			
Net income	\$8,246	\$11,205	\$15,255
Adjustments to reconcile net income to net cash provided by operations			
Depreciation expense	6,129	7,438	9,383
Change in accounts receivable	(2,402)	(6,619)	(9,888)
Change in inventories	(1,861)	(4,202)	(8,225)
Change in accounts payable	898	1,270	1,500
Change in other	880	900	700
Cash provided from operating activities	11,889	9,992	8,725
<u>Cash flows from investing activities</u>			
Capital spending	(13,219)	(20,522)	(28,835)
<u>Cash flows from financing activities</u>			
Sale of bonds	1,830	13,030	21,610
Net Increase in cash	500	2,500	1,500
Beginning cash balance	1,900	2,400	4,900
Ending cash balance	2,400	4,900	6,400

Exhibit C

Profit Plan- Pessimistic Scenario

Statement of Cash Flows

Years Ending December 31

(000)

	<u>2007</u>	<u>2008</u>	<u>2009</u>
<u>Cash flows from operations</u>			
Net income	\$13,600	\$11,500	\$10,900
Adjustments to reconcile net income to net cash provided by operations			
Depreciation expense	9,400	9,400	9,400
Change in accounts receivable	-	3,000	3,000
Change in inventories	-	2,000	1,700
Change in accounts payable	-	(1,500)	(500)
Change in other	-	(400)	(100)
Cash provided from operating activities	23,000	24,000	24,400
<u>Cash flows from investing activities</u>			
Capital spending	(9,400)	(9,400)	(9,400)
<u>Cash flows from financing activities</u>			
Payment on bonds	(13,500)	(14,500)	(14,900)
Net increase in cash	9,200	15,600	12,800
Beginning cash balance	9,790	18,990	34,590
Ending cash balance	<u>18,990</u>	<u>34,590</u>	<u>47,390</u>
<u>Other Key Data</u>			
Sales	\$144,400	137,180	133,751
Operating income	28,158	26,064	24,744