2-7 Free Cash Flow: The Cash Flow Available for Distribution to Investors

So far in the chapter we have focused on financial statements as presented in the annual report. When you studied income statements in accounting, the emphasis was probably on the firm's net income. However, the intrinsic value of a company's operations is determined by the stream of cash flows that the operations will generate now and in the future. To be more specific, the value of operations depends on all the future expected **free cash flows (FCF)**, defined as after-tax operating profit minus the amount of new investment in working capital and fixed assets necessary to sustain the business. *Therefore, the way for managers to make their companies more valuable is to increase free cash flow now and in the future.*

Notice that FCF is the cash flow *available for distribution to all the company's investors after the company has made all investments necessary to sustain ongoing operations.* How successful were MicroDrive's managers in generating FCF? In this section, we will calculate MicroDrive's FCF and evaluate the performance of MicroDrive's managers.

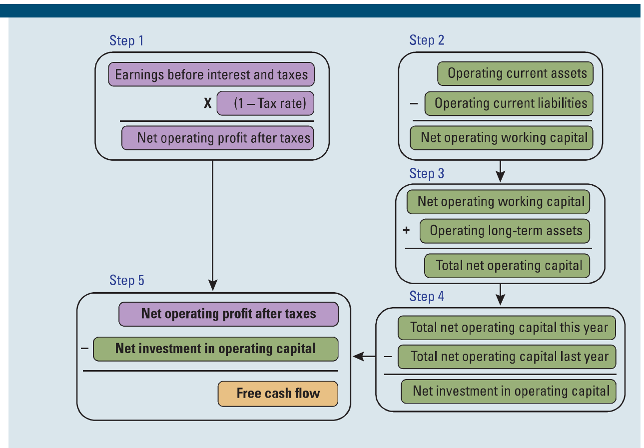
Figure 2-5 shows the five steps in calculating free cash flow. As we explain each individual step in the following sections, refer back to Figure 2-1 to keep the big picture in mind.

2-7a Net Operating Profit after Taxes (NOPAT)

If two companies have different amounts of debt, thus different amounts of interest charges, they could have identical operating performances but different net incomes—the one with more debt would have a lower net income. Net income is important, but it

FIGURE 2-5

Calculating Free Cash Flow



© Cengage Learning 2014