Owner Earnings vs. Free Cash Flow

Managers thinking about accounting issues should never forget one of Abraham Lincoln's favorite riddles: "How many legs does a dog have if you call his tail a leg?" The answer: "Four, because calling a tail a leg does not make it a leg." – Warren Buffett

Though many people consider free cash flow and owner earnings to be one in the same, this is not always the case.

This report discusses the differences between Free Cash Flow and Owner Earnings.

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In his 1986 Letter to Berkshire Hathaway shareholders, Warren Buffett laid out a definition and equation for "owner earnings" – a number that he said is "the relevant item for valuation purposes – both for investors in buying stocks and for managers in buying entire businesses."

What is owner earnings? Before we get into a full explanation, let's lay forth Buffett's formula, as written in the aforementioned letter:

"[Owner earnings] represent (a) reported earnings plus (b) depreciation, depletion, amortization, and certain other non-cash charges...less (c) the average annual amount of capitalized expenditures for plant and equipment, etc. that the business requires to fully maintain its long-term competitive position and its unit volume."

It's a mouthful; hence, the need for the discussion contained herein.

Of course, investors as a group tend to have a need for immediate gratification and tend to seek out a single, simple, quick formula for investing. Because of those needs, free cash flow was born as the "armchair investor's" owner earnings.

Though at times free cash flow and owner earnings are substantially the same, there are times that they differ greatly which can have a very significant impact on an investor's estimation of intrinsic value.

This report will outline the major differences between owner earnings and free cash flow. It assumes that the reader has, at the very least, a rudimentary understanding of financial terms and financial statements.

For additional information and more examples, visit Joe Ponzio's www.FWallStreet.com.

The Start-Up

X-Widget Incorporated

For this discussion of free cash flow versus owner earnings, we'll start by analyzing a fictional company: X-Widget Incorporated. In doing so, the reader should end up with a strong grasp of how the income statement, balance sheet, and statement of cash flows are tied together to give a clear picture of the financial health and performance of a business.

X-Widget Inc. is a start-up company in the business of selling widgets. To start X-Widget Inc., the owner – Bob – decides to bear the costs of incorporating so that X-Widget starts with a clean slate. His attorney creates 10,000 shares of stock and gives Bob 1,000 shares, each with a par value of $1.00. Bob then invests $50,000. Thus, before any sales and before any other business is conducted, X-Widget's income statement is zero – no income or expenses – and its day 1 (in this case, January 1) balance sheet is as follows:

	January 1, 2006
Assets	
Current Assets:	
Cash & Cash Equivalents	$ 50,000
Accounts Receivable	-
Inventory	-
Total Current Assets	50,000
Total Assets	50,000
Liabilities & Stockholders' Equity	
Current Liabilities:	
Accounts Payable	-
Accrued Expenses	-
Total Current Liabilities	-
Stockholders' Equity:	
Common Stock, 10,000 shares authorized, 1,000 issued and outstanding	1,000
Additional Paid-In Capital	49,000
Total Stockholders' Equity	50,000
Total Liabilities & Stockholders' Equity	$ 50,000

Following this balance sheet is pretty straightforward. Bob put $50,000 into his business' checking account; hence, $50,000 in Cash & Cash Equivalents. It wasn't a loan to the company; rather, Bob *invested* in his company. His 1,000 shares of stock have a "par value" of $1.00 per share – or, $1,000. When he invested $50,000 into his company, $1,000 of that went to cover the $1,000 par value of stock and the rest went in as "Additional Paid-In Capital" – money Bob invested above and beyond the par value of the stock.

In this simple start-up example, the balance sheet tells just about the whole story to this point. In a more complex example, investors would definitely want to see a statement of cash flows. Let's look at the cash flows for this period, and then get into business:

	For the period ended January 1, 2006
Cash flows from operating activities:	
Net Income	$ -
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization	-
Changes in operating assets and liabilities:	
Accounts receivable	-
Inventory	-
Accounts payable	-
Accrued expenses	-
Net cash provided by operating activities	-
Cash flows from investing activities:	
Purchases of property and equipment	-
Net cash flows from investing activities	-
Cash flows from financing activities:	
Proceeds from issuance of treasury stock	1,000
Changes in additional paid-in capital	49,000
Net cash flows from financing activities	$ 50,000
Cash & Cash equivalents, beginning	-
Cash & Cash equivalents, ending	$ 50,000

As you can see from this statement of cash flows, nothing was generated from the income statement (the "net income") and you saw that there were no changes in inventories, accounts payable/receivable, etc. That is, there was absolutely no cash flow from "operating activities" because the business did not start operating. No property or equipment was purchased; so, there was no cash flow from "investing activities". The balance sheet showed $50,000 of cash – $50,000 more than it had before Bob invested. His investment is reflected in the cash flows from "financing activities".

The First Sale (and Quarter)

Now that X-Widget Inc. has been funded, it is ready to hit the ground running. Bob buys a widget stamp – the $20,000 machine he desperately needs to start making widgets. He spends $1,000 on business cards, brochures, and other marketing materials. In addition, his new business phone is going to cost him $50 a month.

Ready to make his first millions, Bob hires a commission-only sales rep to pound the streets and drum up business. Bob estimates that the cost of manufacturing a widget is $5,000. If he sells them for $10,000 and gives the sales rep a 25% commission ($2,500), Bob will turn an operating profit of 25%, or

$2,500 for each widget sold ($10,000 *minus* $2,500 in commissions *minus* $5,000 cost to produce = $2,500).

By the way: To keep things simple, Bob will be operating out of his garage and won't be paying any rent or taking any home write-offs.

On February 15, 2006, the sales rep brings in an order for five widgets – a total order of $50,000. Bob records the sale in his accounting software and gets to making the product. It takes six weeks to make the widgets, including delivery, and the customer has thirty days to pay upon acceptance. Assuming the customer holds payment until the last possible moment, Bob should collect a check for $50,000 around the end of April.

The first quarter comes to a close on March 31, 2006, and Bob prepares his financial statements:

	January 1, 2006 to March 31, 2006
Income Statement	
Gross Revenues	$ 50,000
Cost of goods sold	(25,000)
Gross Operating Profit	25,000
Expenses	
Marketing	(1,000)
Telephone	(150)
Commissions	(12,500)
Depreciation	(500)
Total Expenses	(14,150)
Earnings, before taxes	10,850
Provision for taxes	(1,628)
Net Income	$ 9,222
Net Income per Share	$ 9.22

Not many businesses turn a profit their very first quarter. By traditional measures (particularly those on Wall Street), Bob's business is doing *extremely* well. We now turn to check out his balance sheet:

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	March 31, 2006
Assets	
Current Assets:	
Cash & Cash Equivalents	$ 272
Accounts Receivable	50,000
Inventory	–
Total Current Assets	50,272
Plant, Property, & Equipment, net	19,500
Total Assets	69,772
Liabilities & Stockholders' Equity	
Current Liabilities:	
Accounts Payable	50
Accrued Expenses	10,500
Total Current Liabilities	10,550
Stockholders' Equity:	
Common Stock, 10,000 shares authorized, 1,000 issued and outstanding	1,000
Additional Paid-In Capital	49,000
Retained Earnings	9,222
Total Stockholders' Equity	59,222
Total Liabilities & Stockholders' Equity	$ 69,772

Things seem to be in order. Shareholder equity is up $9,222 – or 18% – from when X-Widget started just three months earlier. We see the $50,000 order under Accounts Receivable. That is the sale that is outstanding with the customer. X-Widget just made delivery of the product yesterday and the customer has thirty days to pay the $50,000.

We see cash of just $272. We'll get to that in the statement of cash flows.

The company has some physical assets in the form of a $20,000 widget stamp. In this case, X-Widget Inc. is depreciating it over ten years, at the rate of $2,000 a year, or $500 a quarter. So, Plant, Property, & Equipment (PPE) shows the $20,000 widget stamp *minus* $500 in depreciation for the period.

Accounts Payable is $50. The phone bill is $50 a month. As of March 31, 2006, X-Widget had received three $50 phone bills for a total phone expense of $150. We saw that on the income statement. The phone bill is due on the tenth day of the month following the end of the billing cycle; so, X-Widget Inc. has *received* three bills, but has only paid two of them. The most recent bill (for $50) for the month of March is due on April 10th. Thus, the company has an Accounts Payable balance of $50.

X-Widget Inc. racked up $10,500 in Accrued Expenses. We'll get to that in the statement of cash flows.

Finally, the company had $9,222 of net income, which translates into $9,222 of Retained Earnings under Shareholder Equity.

If, at this point, you are thinking about the $10,500 of Accrued Expenses or the anemic $272 of cash in the bank, you are starting to see the absurdity of looking solely at the income statement. Let's move on to the company's statement of cash flows:

	January 1, 2006 to March 31, 2006
Cash flows from operating activities:	
Net Income	$ 9,222
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization	500
Changes in operating assets and liabilities:	
Accounts receivable	(50,000)
Inventory	–
Accounts payable	50
Accrued expenses	10,500
Net cash provided by operating activities	(29,728)
Cash flows from investing activities:	
Purchases of property and equipment	(20,000)
Net cash flows from investing activities	(20,000)
Cash flows from financing activities:	
Proceeds from issuance of treasury stock	1,000
Changes in additional paid-in capital	49,000
Net cash flows from financing activities	$ 50,000
Cash & Cash equivalents, beginning	–
Cash & Cash equivalents, ending	$ 272

For illustrative purposes, we'll begin from the bottom and work backwards. We know that the company had absolutely no cash at the beginning of the quarter (just before Bob invested his $50,000). Looking at the balance sheet, we also know that the company has just $272 in the bank. That takes care of the "beginning and ending" lines of Cash & Cash equivalents.

Moving up to "financing activities": Bob invested $50,000 into his company on January 1, 2006. We went through that before. Suffice it to say that Bob did not invest or withdraw any money during this quarter.

Moving up to "investing activities": Bob spent $20,000 on a widget stamp – the equipment he needs to make the widgets that his sales rep will sell. The widget stamp required a cash outlay of $20,000; thus, this figure is negative. X-Widget Inc. did not have any other investing activity.

Finally, we move up to "operating activities": We need to reconcile the $9,222 of net income X-Widget reported on its income statement to the actual cash consumed or generated by the operations of the business. In this case, we start with the $9,222 of net income, because that was the reported amount. Now, we add and subtract operating items that required or generated cash that was not otherwise reflected in the income statement.

First, depreciation of $500. Rather than taking a $20,000 deduction on the company's income statement, Bob is able to write off a piece of the widget stamp for each of the next ten years. In this case, Bob is writing $500 off his tax return each quarter for the next forty quarters. Although it is a perfectly legal write-off, the depreciation does not require a cash outlay; so, we add the depreciation back in to the $9,222 as we reconcile net income to net cash from operations.

Next, Accounts Receivable of $50,000. X-Widget Inc. recorded $50,000 of revenue, but has not yet collected that revenue; so, it is a charge that affected net income from operations, but did not actually provide (or require) cash from operations. So, we have to back out the $50,000 from net income by showing a *negative* number for the increase in Accounts Receivable.

Inventory. Bob has not manufactured any inventory that has yet to be sold; so, this is unchanged.

Accounts Payable. X-Widget Inc. showed a $150 expense for the phone bill, but it only paid out $100. (See the "Accounts Payable" discussion above.) The company wrote off $150, but only used $100 of cash; so, Accounts Payable increased by $50 and we need to add that increase in to further reconcile net income to net cash from operations.

Finally, Accrued Expenses. Here's where it gets hairy. Recall that Bob offered his sales associate a 25% commission for selling widgets. With a $50,000 order in hand, the sales associate earned a $12,500 commission. After spending $20,000 on the widget stamp, spending another $25,000 on the products needed to manufacture the widgets, having paid $100 of phone bills, having spent $1,000 on marketing materials, and having written Uncle Sam a check for $1,628 in taxes, Bob did not have enough cash left to pay the full commission. Bob had spent $47,728 of the $50,000 in the bank leaving him with just $2,272; so, he gave his sales associate $2,000 upfront and promised him the other $10,500 when the customer paid in full.

So, X-Widget has to carry a $10,500 Accrued Expense – $12,500 in commission deducted from net income *minus* $2,000 of cash that was paid to the sales associate. That is, $12,500 affected net income, but only $2,000 affected cash, leaving a balance of $10,500.

And *that's* how this profitable business went from $50,000 in the bank to just $272.

Bob vs. The Government

GAAP Earnings vs. Free Cash Flow vs. Owner Earnings

As far as Uncle Sam is concerned, Bob's business is thriving. With $10,850 of pre-tax earnings, Uncle Sam wants his $1,628 piece of the pie. Wall Street would also rejoice in Bob's success. With a modest price-to-earnings ratio of 10, Bob's stock would be trading at $92.22 ($9.22 per share x 10). He'd be able to sell his business in the stock market for $92,220 – his 1,000 shares times $92.22 a share.

And perhaps he should.

Let's take a look at X-Widget from Bob's perspective – an owner's perspective – by calculating owner earnings and free cash flow.

Free cash flow is simply calculated as:

Net cash provided by operating activities
\+ Purchases of property and equipment (Capital Expenditures, remember this is negative)

In the case of X-Widget, this would come out to:

	$ (29,728)	Net cash provided by operating activities
+	$ (20,000)	Purchases of property and equipment
	$ (49,728)	Free Cash Flow

In this case, we see that the business' operations – after spending the money to buy the widget stamp, without which there would be *no* operations – required $49,728 in cash. Now, let's get owner's earnings:

Reported Earnings
\+ Depreciation, Depletion, and Amortization
\+ Certain Other Non-Cash Charges (that is, changes in working capital)
\+ Average Annual Capital Expenditures (when expressed as a negative number)

We'll go line-by-line:

	$	9,222	Net Income
+	$	500	Depreciation
+	$	(50,000)	Accounts Receivable
+	$	50	Accounts Payable
+	$	10,500	Accrued Expenses
+	$	(913)	Average Annual (in this case, Quarterly) Capital Expenditures
	$	(30,641)	Owner Earnings

If you are thinking, "Everything makes sense until the $ (913) of capital expenditures. You lost me there," don't worry. Here's the first discrepancy between free cash flow and owner earnings:

Free cash flow generally assumes that *all* capital expenditures are "average annual" capital expenditures. Though it is entirely possible that X-Widget Inc. would have to spend $20,000 each quarter to maintain its unit output, it's totally impractical and improbable. If the widget stamp is only good for five widgets, and then it has to be replaced for $20,000, X-Widget could not possibly sell them for just $10,000 a piece.

Owner earnings requires a bit more insight and thought. In this case, X-Widget expects to run the widget stamp for ten years, after which it will sell it for scrap for about $3,000. In the first year, it won't require any maintenance; in the second year, Bob will have to invest $500 for regular maintenance of the

widget stamp. As the machine ages, Bob will have to spend more and more to keep it running, until it makes sense to scrap the machine and buy a new one.

To "to fully maintain its long-term competitive position and its unit volume," X-Widget will replace the machine every ten years, and will invest a total of $19,500 over those ten years to keep it running smooth – to maintain its unit volume.

So, X-Widget's capital expenditures for the next ten years would look like this:

Year 1:	$	(20,000)	Buy the widget stamp
Year 2:	$	(500)	Regular maintenance
Year 3:	$	(1,000)	Regular maintenance
Year 4:	$	(1,500)	Regular maintenance
Year 5:	$	(2,000)	Regular maintenance
Year 6:	$	(2,500)	Regular maintenance
Year 7:	$	(3,000)	Regular maintenance
Year 8:	$	(3,000)	Regular maintenance
Year 9:	$	(3,000)	Regular maintenance
Year 10:	$	(3,000)	Regular maintenance
Year 10:	$	3,000	Sale of widget stamp at end of year 10
Total:	$	(36,500)	Total Capital Expenditures over ten years
Annual:	$	(3,650)	Average Annual Capital Expenditures
Quarterly:	$	(912.50)	Average Quarterly Capital Expenditures

After Year 10, X-Widget would shell out another $20,000 – or the going rate at that time – for a new widget stamp and start the cycle again.

And so, looking at three different measures, we see three very different stories. GAAP earnings tell us Bob's business is very profitable and that Bob is making money hand-over-fist. We certainly know that's *not* the case because Bob shelled out $50,000 and still can't afford to pay his sales associate a commission (nor can he pay himself a dime!)

Looking at Free Cash Flow, we see a business that is operating at a $49,728 deficit. Though that was absolutely the case for the first quarter, we shouldn't expect that to be the case going forward, assuming it's business as usual. Bob will not need to spend $20,000 a quarter on capital expenditures.

With Owner Earnings, we see a business that required $30,641 of cash for its operations in this quarter. While Free Cash Flow gives a more accurate portrayal of the particular quarter's performance, Owner Earnings takes a step back and looks at the business as an ongoing concern over many years.

At this point, you may be thinking, "Well, I like to play it safe; so, I think Free Cash Flow is better." Let's look at a few more quarters before you jump to any conclusions. Later in this discussion, we'll talk about a few other caveats of Free Cash Flow that can make it a somewhat less attractive than owner earnings – particularly when there is more to the cash flow statement than in the following, simplified example.

X-Widget Performance

Three Years of Financial Performance

Income Statement, for the fiscal years ended December 31,

	2008	2007	2006
Gross Revenues	$ 340,000	$ 260,000	$ 170,000
Cost of goods sold	(163,200)	(128,700)	(85,000)
Gross Operating Profit	176,800	131,300	85,000
Gross Margin	52%	51%	50%
Expenses			
Marketing	(4,000)	(3,200)	(1,800)
Telephone	(600)	(600)	(600)
Commission	(85,000)	(65,000)	(42,500)
Depreciation	(2,150)	(2,050)	(2,000)
Salaries	(76,000)	(58,000)	(36,000)
Total Expenses	(167,750)	(128,850)	(82,900)
Earnings, before taxes	9,050	2,450	2,100
Provision for taxes	(1,358)	(368)	(315)
Net Income	$ 7,693	$ 2,083	$ 1,785
Earnings Per Share	$ 7.69	$ 2.08	$ 1.79

At a quick glance, you can see that X-Widget has been increasing its gross margin. It's costing less and less to make more and more widgets. This could be a function of lower material costs; or, it could be that X-Widget is getting better pricing because of the volume of business it is doing with its suppliers. (You'd have to check the annual reports to find out.)

The company has been increasing its marketing efforts which can be a good thing if the marketing is effective. Depreciation has been creeping up – a result of the ongoing "regular maintenance" expenditures laid out previously.

Bob began taking a salary in 2006, and has been increasing that over time – from $36,000 to $76,000.

Let's turn to the balance sheets on the next page.

X-Widget Performance

Three Years of Financial Performance

Balance Sheet, as of December 31,

	2008	2007	2006
ASSETS			
Current Assets			
Cash & Cash Equivalents	$ 1,311	$ 7,468	$ 3,835
Accounts Receivable	30,000	25,000	20,000
Inventories	15,000	5,000	10,000
Total Current Assets	46,311	37,468	33,835
PPE, net	15,300	16,450	18,000
TOTAL ASSETS	61,611	53,918	51,835
LIABILITIES & STOCKHOLDERS' EQUITY			
Current Liabilities			
Accounts Payable	50	50	50
Accrued Expenses	–	–	–
Total Current Liabilities	50	50	50
Stockholders' Equity			
Common Stock, 10,000 shares authorized, 1,000 issued and outstanding	1,000	1,000	1,000
Add'l Paid-In Capital	49,000	49,000	49,000
Retained Earnings	11,561	3,868	1,785
Total Equity	61,561	53,868	51,785
TOTAL LIABILITIES & STOCKHOLDERS' EQUITY	61,661	53,918	51,835

Summary: Each year, X-Widgets has ended the year with more sales outstanding than the prior year – not a cause for joy or concern; it is what it is. We'll see if it's problematic in owner earnings. We also see that the company built an inventory of $10,000 in 2006, depleted it a bit in 2007, and built it back up in 2008. PPE shows the ongoing depreciation of the widget stamp as it becomes less and less valuable.

On the liabilities side, we see that the company ends each year with $50 of Accounts Payable. That is the $50 December phone bill that is due on January 10th of the following year.

Finally, we see that retained earnings has grown as the company continues to show profits each year.

Let's move on to the statement of cash flows.

X-Widget Performance

Three Years of Financial Performance

Statement of Cash Flows, for the fiscal years ended December 31,

	2008	2007	2006
Operating Activities:			
Net Income	$ 7,693	$ 2,083	$ 1,785
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	2,150	2,050	2,000
Changes in operating assets and liabilities:			
Accounts Receivable	(5,000)	(5,000)	(20,000)
Inventories	(10,000)	5,000	(10,000)
Accounts Payable	–	–	50
Accrued Expenses	–	–	–
Net cash provided by Operating activities:	(5,157)	4,133	(26,165)
Investing Activities:			
Capital Expenditures	(1,000)	(500)	(20,000)
Net cash provided by Investing activities:	(1,000)	(500)	(20,000)
Financing Activities:			
Proceeds from issuance of treasury stock	–	–	1,000
Changes in additional Paid-in capital	–	–	49,000
Net cash provided by Financing activities:	–	–	50,000
Cash, beginning	7,468	3,835	–
Cash, ending	1,311	7,468	3,835

And now we can piece together the whole story and come up with Free Cash Flow and Owner Earnings. In this case, we see that the company had $20,000 more in Accounts Receivable at the end of 2006 than it had in the beginning of the year. In 2007, it had $5,000 more than at the end of 2006; in 2008, it had $5,000 more than in 2007. (This is confirmed on the balance sheet.)

We also see how the inventories affected cash – to build the $10,000 inventory reserve in 2006 required $10,000 of cash. In 2007, the company reduced its inventory by $5,000 – that is, it sold $5,000 worth of widgets it did not have to manufacture that year, resulting in additional cash from the net income (thus the positive inventory change in 2007).

Let's get to the Free Cash Flow versus Owner Earnings calculations:

	2008	2007	2006
Free Cash Flow:			
Cash from Operations	$ (5,157)	$ 4,133	$ (26,165)
Capital Expenditures	(1,000)	(500)	(20,000)
Total Free Cash Flow:	(6,157)	3,633	(46,165)
Owner Earnings:			
Net Income	7,693	2,083	1,785
Depreciation	2,150	2,050	2,000
Accounts Receivable	(5,000)	(5,000)	(20,000)
Inventories	(10,000)	5,000	(10,000)
Accounts Payable	–	–	50
Capital Expenditures	(3,650)	(3,650)	(3,650)
Total Owner Earnings:	(8,807)	483	(29,815)

The big difference between these two numbers – in this very simplified example – is that Free Cash Flow does not take into account future capital spending, treating it instead like a one-time event in the past. As Buffett explained, "[Ignoring future capital expenditures implies] that the business being offered is the commercial counterpart of the Pyramids – forever state-of-the-art, never needing to be replaced, improved or refurbished."

With owner earnings, you are attempting to figure out how much cash would be left over for owners if the business budgeted for future capital expenditures. Some businesses do plan and budget very well, thus helping assure investors that capital expenditures will remain fairly constant from year to year. Such is *not* the case with X-Widgets. For example, in 2009 X-Widgets will need to spend $1,500 to maintain its widget stamp machine. The company has just $1,311 in cash.

As sales come in, Bob will figure out how to budget for this year's spending. What about next year? What will happen in 2016 when the widget stamp will have to be entirely replaced for $20,000 (or more)? In this example, Free Cash Flow shows a "tough" business; Owner Earnings shows a business that is headed for certain trouble if it continues on its present course. Come 2016, Bob will have to put up more cash, thus hurting his return on investment. In the public markets, this is the equivalent of your company issuing debt or stock, thereby diluting your ownership and hurting your return on investment (via reduced intrinsic value).

The difference between Free Cash Flow and Owner Earnings extends far beyond the projection of capital expenditures. To better understand, let's look at a more complicated example.

General Motors Corporation

Three Years of Financial Performance

Partial Statement of Cash Flows, for the fiscal years ended December 31,

(in millions)

	2007	2006	2005
Cash flows from operating activities			
Net loss	$(38,732)	$ (1,978)	$(10,417)
Less income from discontinued operations	$ 4,565	$ 445	$ 313
Less cumulative effect of a change in accounting principle	$ -	$ -	$ (109)
Loss from continuing operations	$(43,297)	$ (2,423)	$(10,621)
Adjustments to reconcile loss from continuing operations to net cash provided by (used in) continuing operating activities:			
Depreciation, impairments and amortization expense	$ 9,513	$ 10,885	$ 15,732
Mortgage servicing rights and premium amortization	$ -	$ 1,021	$ 1,142
Goodwill impairment — GMAC	$ -	$ 828	$ 712
Delphi charge	$ 1,547	$ 500	$ 5,500
Loss on sale of 51% interest in GMAC	$ -	$ 2,910	$ -
Provision for credit financing losses	$ -	$ 1,799	$ 1,074
Net gains on sale of credit receivables	$ -	$ (1,256)	$ (1,741)
Net gains on sale of investment securities	$ -	$ (1,006)	$ (104)
Other postretirement employee benefit (OPEB) expense	$ 2,362	$ 3,567	$ 5,650
OPEB payments	$ (3,751)	$ (3,802)	$ (4,084)
VEBA/401(h) withdrawals	$ 1,694	$ 3,061	$ 3,168
Pension expense	$ 1,799	$ 4,911	$ 2,495
Pension contributions	$ (937)	$ (1,032)	$ (833)
Retiree lump sum and vehicle voucher expense, net of payments	$ -	$ (325)	$ (264)
Net change in mortgage loans	$ -	$(21,578)	$(29,119)
Net change in mortgage securities	$ -	$ 427	$ (1,155)
Provisions for deferred taxes	$ 36,977	$ (4,166)	$ (6,731)
Change in other investments and miscellaneous assets	$ 663	$ (477)	$ (690)
Change in other operating assets and liabilities, net of acquisitions and disposals	$ (3,412)	$ (8,512)	$ 20
Other	$ 4,349	$ 2,318	$ 2,679
Net cash provided by (used in) continuing operating activities	$ 7,507	$(12,350)	$(17,170)
Cash provided by discontinued operating activities	$ 224	$ 591	$ 314
Net cash provided by (used in) operating activities	$ 7,731	$(11,759)	$(16,856)
Expenditures for Property	$ (7,542)	$ (7,902)	$ (8,141)

General Motors Corporation

Analyzing The Numbers

In the case of General Motors, the Free Cash Flow and the Owner Earnings yield drastically different results.

	2007	2006	2005
Free Cash Flow:			
Cash from Operations	$ 7,731	$ (11,759)	$ (16,856)
Capital Expenditures	(7,542)	(7,902)	(8,141)
Total Free Cash Flow	189	(19,661)	(24,997)
Owner Earnings:			
Net Income from continuing operations	(43,297)	(2,423)	(10,621)
Depreciation, Impairments, & Amortization	9,513	10,885	15,732
Change in other operating assets and liabilities, net of acquisitions and disposals	(3,412)	(8,512)	20
Capital Expenditures	(7,893)	(7,893)	(7,893)
Tentative Owner Earnings[1]	(45,089)	(7,943)	(2,762)

(1) After the following discussion about Free Cash Flow versus Owner Earnings, see the discussion on Depreciation vs. Capital Expenditures for a final calculation of GM's Owner Earnings.

The 2007 Free Cash Flow shows that General Motors generated $189 million from its operations, a turnaround from its Free Cash Flow losses of $20 billion and $25 billion in 2006 and 2005, respectively. Focused solely on Free Cash Flow, an investor analyzing the business might see the 2006 loss of $20 billion – $5 billion *better* than in 2005 – as a sign of improvement. When General Motors began generating positive Free Cash Flow in 2007, an investor might mistakenly believe that General Motors had fixed its problems, turned the corner, and was potentially poised for growth.

Owner Earnings tells a different story.

Starting with Net Income (Loss) from continuing operations (we need to see the performance of the ongoing business), we add in depreciation, amortization, and impairments. We add in the net change to working capital (less the change in cash, in this case – "Change in other operating assets and liabilities, net of acquisitions and disposals"). Finally, we take into account the cash outflows for capital expenditures, of which General Motors has had $71 billion over the last nine years, or about $7,893 million a year.

Owner Earnings shows us that General Motors' business burned through $2.7 billion of cash in 2005. Things worsened in 2006 as the business consumed $7.9 billion. Though Free Cash Flow showed 2007 to be the best of the three years, Owner Earnings shows it to be the worst of all – consuming more than $45 billion.

Why the discrepancy? In this case, the capital expenditures had very little effect on the difference between Free Cash Flow and Owner Earnings. Instead, the difference is found in non-cash charges that GM deducted from earnings, but that were added back in when reconciling the statement of cash flows. Free Cash Flow blindly assumes that all of those expenses should benefit owners; Owner Earnings sees many of those expenses as potentially dilutive and/or future commitments, and does not credit owners.

Let me explain with some examples from the General Motors statement of cash flows. I'll touch on and explain some of the common adjustments you'll see on statements of cash flows:

Other postretirement employee benefit (OPEB) expense; OPEB payments: In 2007, General Motors deducted $2,362 from its net income as an OPEB expense, offset by OPEB cash payments of $3,751. The net result of the OPEB expense was a reduction in cash of $1.4 billion. In 2005, GM took a $5.65 billion write-off for the OPEB expense, but only paid out $4.01 billion in cash, netting GM positive cash flow from the OPEB expenses of $1.24 billion.

With Free Cash Flow, the $1.4 billion spent in 2007 is deducted from cash flow from operations; in 2005, Free Cash Flow considers that $1.24 billion as cash generated by operations. Owner Earnings looks at it and says, "At some point, the OPEB expense and OPEB payment will have to cancel each other out because GM can't have a surplus of retirement benefits if everyone retires and cashes out of the plan." Regardless of how much or how little GM management decided to pay into the OPEB, it is a real expense that belongs in net income and should not be reconciled as a "non-cash" charge. It will *eventually* have to be paid; so, we leave it in net income. (It's similar to averaging capital expenditures – the company will *eventually* have to spend the money, even if it doesn't do so this year.)

Provision for deferred taxes. The 2007 statement of cash flows shows a $36.977 billion provision for deferred taxes. Here's the short answer: Eventually, Uncle Sam will want his money; so, to reconcile the tax expense on the net income to any "deferred" taxes is silly. "Accordingly, based on our current circumstances and uncertainty regarding our future taxable income, we recorded full valuation allowances against these net deferred tax assets during the third quarter of 2007. If and when our operating performance improves on a sustained basis, our conclusion regarding the need for full valuation allowances could change, resulting in the reversal of some or all of the valuation allowances in the future."

So, if GM returns to profitability, it will need to pay these taxes. To put it simply, GM reduced its deferred tax assets (a non-current asset, *not* working capital) on its balance sheet from $33.1 billion to $2.1 billion, and experienced an increase in its deferred tax liabilities (a non-current liability, also *not* working capital) of roughly $7 billion. Putting aside the tax dance, keep in mind that Uncle Sam will want to get paid. The 2007 tax bill of $37.2 billion reduced net income.

Free Cash Flow adds in the deferred taxes as though the company will never have to pay them – as if the $37 billion of taxes GM owes to the Government is a gift. According to Free Cash Flow, GM owners could effectively pull that $37 billion of cash out of the business. Uncle Sam would definitely have something to say about that.

Owner Earnings does not reconcile the deferred taxes because it recognizes that GM will eventually have to pay this expense or it will be out of business.

Stock-Based Compensation Expense. Though GM does not have any stock-based compensation expense listed on the statement of cash flows, it is a common item you will likely find on many cash flow statements. When a company issues stock options, it generally expenses those options from net income. Stock options can help a company reduce its tax liability, but do not require a cash outlay. Free Cash Flow presumes that the cash benefit from issuing stock options belongs to owners; so, it adds in the stock-based compensation expense. Owner Earnings does the opposite – it sees stock options for what they are (dilutive to owners) and does not reconcile them. Instead, it leaves the expense alone by using net income and ignoring the stock-based compensation expense on the statement of cash flows.

The Question You Must Ask

Why is this cash here?

When deciding whether or not to include an item in your owner earnings calculation, you must ask yourself, "Why is this cash here (or gone)?" In the case of GM's 2005 OPEB acrobatics, GM ended up with $1.24 billion *more* than it expensed from net income that year. Eventually, GM would have to pay that cash out; so, it is not cash that belongs to owners.

What about those operating assets and liabilities? To best understand *why* you include working capital in your equation, go back to Bob's company – X-Widget Inc. Bob invested $50,000 in his business and showed a GAAP profit in his very first quarter. Still, Bob's business required more than $49,000 of cash to get started. To stay in business, one of two things had to happen:

1. The customer would have to pay the $50,000 (Accounts Receivable); or,
2. Bob would have to come up with more money.

Now, Bob could have reduced his tax liability by issuing stock to his employee rather than paying a commission. Would that have increased his cash flow? Yes and no. On the one hand, Bob would not have to shell out any cash in the form of commission, thereby increasing his cash available for growth; on the other hand, Bob would no longer be sole owner of the company, but a partner with his employee. Bob would effectively dilute his ownership and be entitled to less of the value of the company going forward.

In the Accounts Receivable example, the answer to the question would be: "Because the company has an outstanding order for $50,000" – the cash is here or gone because of operations. In the stock options

example, the answer to the question would be: “Because Bob tried to save cash” – the cash is here or gone because of a decision by management to preserve (or use excess) cash.

General Motors Corporation

Getting to Final Owner Earnings

There is one last step to calculating GM’s Owner Earnings – a step that is not extremely common, but worth noting (and calculating) in this example. Depreciation is a non-cash charge that allows a company to spread the cost of an asset over the course of many years. The idea behind depreciation is that it helps companies smooth out GAAP earnings.

Over the long-term, the difference between total depreciation and total capital expenditures should be zero. That is, if a company spends $10,000 on a piece of equipment and the IRS allows the company to depreciate the asset over ten years, the company will take a $1,000 depreciation expense in each of the ten years. At the end of ten years, the company will have paid $10,000 for the capital expenditure and will have “earned” via a tax deduction $10,000 ($1,000 a year *times* 10 years) in depreciation.

This is not to say that you should take the short-hand method of merely cancelling out depreciation and capital expenditures from your calculations. While the above is true when looking at a business from its starting point until the point at which it winds up its operations, it is not necessarily true in any given year or so long as the business is an ongoing operation.

This is where capital expenditures and depreciation get tricky. When a company is spending a lot more on capital expenditures than it is recording as depreciation, it is for one of two reasons:

1. The company must make capital expenditures that exceed depreciation merely to maintain competitive; and/or,
2. The business is making capital expenditures above and beyond its requisite “regular maintenance” capital expenditures. (These are usually called “Growth Capital Expenditures” versus “Maintenance Capital Expenditures” though most annual reports do not separate the two for investors; so, an investor must make educated assumptions about capital expenditures. Such appeared to be the case when we analyzed Wal-Mart: www.fwallstreet.com/blog/44.htm.)

GM has precisely the opposite – depreciation and amortization greatly exceeds capital expenditures, an obviously impossible situation since future capital expenditures have to be made to cause future depreciation. This would lead us to one of two conclusions:

1. GM is not spending enough to maintain its plant, property, and equipment; or,
2. This is a temporary state of affairs due to the purchase of a long-life assets (such as a building) or because goodwill or other intangibles are being amortized over extremely long periods.

In this case, we can’t assume this happy state of “taking bigger tax write-offs than we’re normally allowed” will continue forever. Because we know that, over the long-term, capital expenditures and depreciation will provide a net sum of zero, and because we’re not worried about *understating* capital

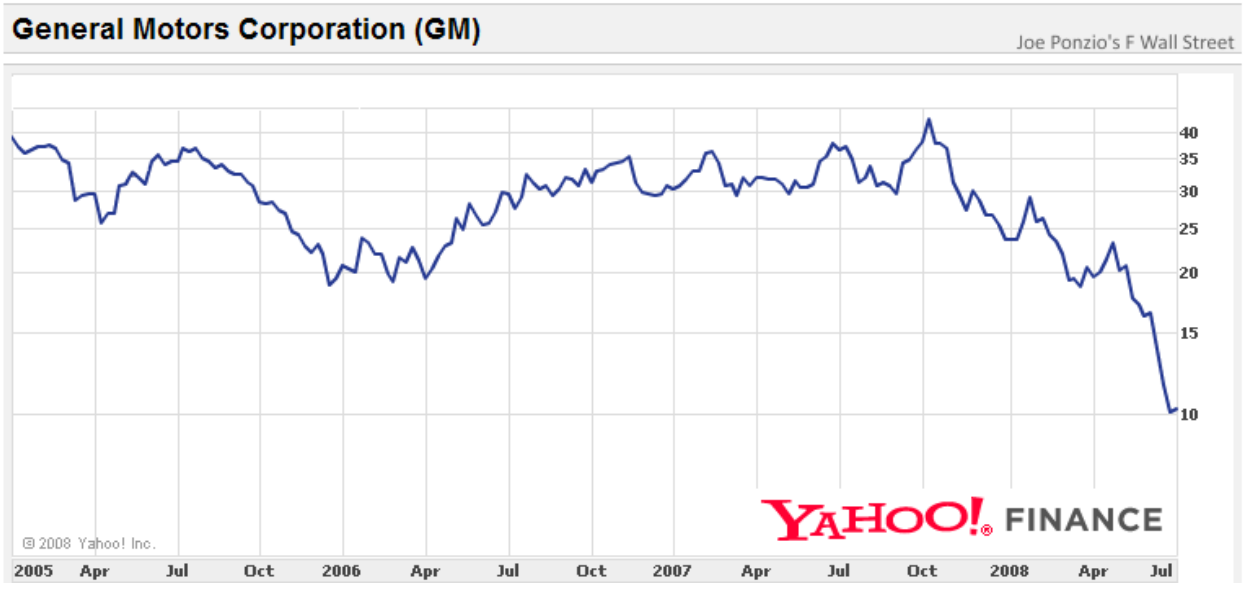
expenditures (because depreciation is *greater than* capital expenditures), we can assume that depreciation and capital expenditures are the same for General Motors under normal conditions. Any excess benefit it receives today by taking large depreciation write-offs will be offset in the future by larger capital expenditures.

So, our final owner earnings calculation for GM would be as follows:

	2007	2006	2005
Owner Earnings:			
Net Income from continuing operations	(43,297)	(2,423)	(10,621)
Change in other operating assets and liabilities, net of acquisitions and disposals	(3,412)	(8,512)	20
Final Owner Earnings	(46,709)	(10,935)	(10,601)

In this case, GM's automotive business is even uglier than we thought. The company's operations required nearly $11 billion of cash in 2005 and 2006. In 2007, the business was hammered even worse, requiring nearly $47 billion of excess cash just to keep the cars coming off the assembly line.

How did it cover this shortfall? It began selling businesses, selling finance receivables, playing games with the pension and OPEB, refinancing debt, and working some tax magic. Of course, as the business deteriorated, so too did the stock price:



Price follows value. When the value deteriorates rapidly (as is often the case when a business' operations are cash-hungry beasts), the stock price is usually not too far behind.

Owner Earnings vs. Free Cash Flow

Putting It Into Perspective

We've seen the trouble with relying solely on GAAP earnings. Bob's business was profitable from a GAAP / IRS / Wall Street perspective; still, if his first customer didn't pay, Bob was out of business.

Free Cash Flow is a short-hand method for scanning companies. When a company has minimal reconciliation to net income and fairly steady and predictable capital expenditures, Free Cash Flow and Owner Earnings are substantially the same. In that case, either can be used for valuation purposes. Because of the investor's margin of safety, a minor difference between Free Cash Flow and Owner Earnings would be insignificant when calculating intrinsic value.

Owner Earnings is the best indicator of cash flow from the *operating activities* of the business, regardless of how management strives to juggle profitability and cash flow. When a company has a large amount of non-cash charges to GAAP earnings, Owner Earnings is generally a more reliable indicator of business performance than Free Cash Flow. In fact, depending on how creative, aggressive, or cautious management gets, Free Cash Flow can be extremely skewed in these cases, as we saw with General Motors.

It is important to note that, while Free Cash Flow and Owner Earnings can be substantially the same, they can also be substantially different. Focus on Owner Earnings, and use Free Cash Flow as a short-hand only when it makes sense.

Questions? Comments? Visit Joe Ponzio's F Wall Street: www.FWallStreet.com.

Best of luck with your investing,

Joe Ponzio
