Free Cash Flows = EBIT \* (1-tax rate) + Depreciation & Armortization – Changes in Working Capital = Capital expenditure.

|  |  |
| --- | --- |
| [EBIT](https://en.m.wikipedia.org/wiki/Earnings_before_interest_and_taxes) x (1-[Tax rate](https://en.m.wikipedia.org/wiki/Tax_rate)) | Current Income Statement |
| + [Depreciation](https://en.m.wikipedia.org/wiki/Depreciation) & [Amortization](https://en.m.wikipedia.org/wiki/Amortization_%28business%29) | Current Income Statement |
| - Changes in [Working Capital](https://en.m.wikipedia.org/wiki/Working_Capital) | Prior & Current Balance Sheets: Current Assets and Liability accounts |
| - [Capital expenditure](https://en.m.wikipedia.org/wiki/Capital_expenditure) (CAPEX) | Prior & Current Balance Sheets: Property, Plant and Equipment accounts |

When net profit and tax rate applicable are given, you can also calculate it by taking:

|  |  |
| --- | --- |
| **Element** | **Source** |
| Net Profit | Current Income Statement |
| + [Interest expense](https://en.m.wikipedia.org/wiki/Interest_expense) | Current Income Statement |
| - Net Capital Expenditure (CAPEX) | Current Income Statement |
| - Net changes in [Working Capital](https://en.m.wikipedia.org/wiki/Working_Capital) | Prior & Current Balance Sheets: Current Assets and Liability accounts |
| - [Tax shield](https://en.m.wikipedia.org/wiki/Tax_shield) on Interest Expense | Current Income Statement |
| = **Free Cash Flow** |  |

|  |  |
| --- | --- |
| **Element** | **Data Source** |
| Cash Flows from Operations | Statement of Cash Flows: section 1, from Operations |
| - Investment in operating Capital | Statement of Cash Flows: section 2, from Investment |
| = **Free Cash Flow** |  |

Difference between net income and free cash flows

|  |  |  |  |
| --- | --- | --- | --- |
| **Measurement Type** | **Component** | **Advantage** | **Disadvantage** |
| Free Cash Flow | Prior period net investment spending | Spending is in current dollars | Capital investments are at the discretion of management, so spending may be sporadic. |
| Net Income | Depreciation charge | Charges are smoothed, related to cumulative prior purchases | Allowing for typical 2% inflation per year, equipment purchased 10 years ago for $100 would now cost about $122. With 10 year straight line depreciation the old machine would have an annual depreciation of $10, but the new, identical machine would have depreciation of $12.2, or 22% more. |

Why is free cash flows used?

* Free cash flow measures the ease with which businesses can grow and pay [dividends](https://en.m.wikipedia.org/wiki/Dividends) to shareholders. Even profitable businesses may have negative cash flows. Their requirement for increased financing will result in increased financing cost reducing future income.
* According to the [discounted cash flow](https://en.m.wikipedia.org/wiki/Discounted_cash_flow) valuation model, the [intrinsic value](https://en.m.wikipedia.org/wiki/Intrinsic_value_%28finance%29) of a company is the [present value](https://en.m.wikipedia.org/wiki/Present_value) of all future free cash flows, plus the cash proceeds from its eventual sale. The presumption is that the [cash flows](https://en.m.wikipedia.org/wiki/Cash_flow) are used to pay dividends to the shareholders. Bear in mind the lumpiness discussed below.
* Some investors prefer using free cash flow instead of [net income](https://en.m.wikipedia.org/wiki/Net_income) to measure a company's financial performance, because free cash flow is more difficult to manipulate than [net income](https://en.m.wikipedia.org/wiki/Net_income). The problems with this presumption are itemized at [cash flow](https://en.m.wikipedia.org/wiki/Cash_flow) and [return of capital](https://en.m.wikipedia.org/wiki/Return_of_capital).
* The payout ratio is a metric used to evaluate the sustainability of distributions from REITs, Oil and Gas Royalty Trusts, and Income Trust. The distributions are divided by the free cash flow. Distributions may include any of income, flowed-through capital gains or [return of capital](https://en.m.wikipedia.org/wiki/Return_of_capital).

Information courtesy of:

Brealey, Richard A.; Myers, Stewart C.; Allen, Franklin (2005). [*Principles of Corporate Finance*](https://en.m.wikipedia.org/wiki/Principles_of_Corporate_Finance) (8th ed.). Boston: McGraw-Hill/Irwin

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