

A. Hertz Corp. (\$ millions)

| | 1989 | 1990 | 1991 |
|------------------------------------|---------|---------|---------|
| Reported cash flow from operations | (117) | 92 | 286 |
| Add back: purchases of equipment | 3,003 | 4,024 | 4,016 |
| Subtract: sales of equipment | (2,354) | (3,434) | (3,784) |
| Adjusted cash flow from operations | 532 | 682 | 518 |

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- B.** As reported, cash flow from operations shows steady improvement over the period 1989-1991, changing from a negative to a positive amount. After adjustment, the trend is eliminated; cash flow from operations is lower in 1991 than in either 1989 and 1990. The improvement in reported cash flow from operations was the result of reducing Hertz's net investment in rental equipment.

| | | | |
|----------------------------------|---------|---------|---------|
| Reported cash flow for investing | (133) | (79) | (72) |
| Subtract: purchases of equipment | (3,003) | (4,024) | (4,016) |
| Add back: sales of equipment | 2,354 | 3,434 | 3,784 |
| Adjusted cash flow for investing | (782) | (669) | (304) |

- D.** Reported cash flow for investing shows little change over the three year period. Cash flow for investing drops by more than half in 1991. After reclassification it reflects the sharp drop in net car and truck purchases in that year.

- E.** Free cash flow can be defined as cash flow from operations less investment required to maintain productive capacity. If we assume that Hertz's investments are solely to maintain existing capacity, then free cash flow equals cash flow from operations less cash flow for investing:

| | 1989 | 1990 | 1991 |
|--|---------|------|-------|
| Reported cash flow from operations | (\$117) | \$92 | \$286 |
| Less: reported cash flow for investing | -133 | -79 | -72 |
| Equals: free cash flow | (\$250) | \$13 | \$214 |

Note that reclassification of purchases and sales of revenue equipment has no effect on free cash flow:

| | 1989 | 1990 | 1991 |
|--|-------|-------|-------|
| Adjusted cash flow from operations | 532 | 682 | 518 |
| Less: adjusted cash flow for investing | (782) | (669) | (304) |
| Equals: free cash flow | (250) | 13 | 214 |

Thus by defining free cash flow in a manner which subtracts out all expenditures required to maintain the operating capacity of the firm, whether capitalized or not and regardless of classification, the effects of accounting and reporting differences can be overcome. This solution requires, of course, the identification of the amounts of such items.

- F.** When equipment is purchased, the full amount is reported as an operating cash outflow. For leased equipment, only the periodic lease payments are reported as operating cash outflows. Thus, for Hertz, leasing increases reported cash flow from operations.
- G.** When equipment purchases are classified as investing cash flows, then leasing reduces operating cash flows relative to purchases. That is because the outflow connected with purchases (or any other capitalized expenditure) is never classified as an operating outflow.