Georgia Tech Financial Analysis Lab
800 West Peachtree Street NW
Atlanta, GA 30332-0520
404-894-4395
http://www.mgt.gatech.edu/finlab

Dr. Charles W. Mulford, Director
Invesco Chair and Professor of Accounting
charles.mulford@mgt.gatech.edu

Kerianne Maloney
Graduate Research Assistant

Free Cash Flow and Compensation: A Fashionable Fad or Something More?

Executive Summary

As instances of alleged cases of accounting fraud and earnings management have increased in recent years there has been a "discovery" of sorts of free cash flow by investors, analysts and the financial press. Such a development is interesting because certainly free cash flow is not new. It has always been of primary importance to investors for purposes of valuation.

References to the metric have grown markedly in recent years and it is now being used in new and varied ways. One such use is in the calculation of incentive compensation.

This report provides evidence of the recent increase in interest in free cash flow and surveys its use in incentive compensation agreements.

Portions of this report were adapted from the upcoming book, *Creative Cash Flow Reporting: Uncovering Sustainable Financial Performance*, by C. Mulford and E. Comiskey, scheduled for publication later this year by John Wiley & Sons.

June 2004

Georgia Tech Financial Analysis Lab
College of Management
Georgia Institute of Technology
Atlanta, GA 30332-0520

Georgia Tech Financial Analysis Lab
The Georgia Tech Financial Analysis Lab conducts independent stock market research. Information collected without bias is vital to effective investment decision-making. Accordingly, we think that independent research organizations, such as our own, have an important role to play in providing information to market participants.

Because our Lab is housed within a university, all of our research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Our focus is on issues that we believe will be of interest to a large segment of stock market participants. Depending on the issue, we may focus our attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in our work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. We define earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, our research may look into reporting practices that affect either earnings or cash flow, or both. At times our research may look at stock prices generally, though from a fundamental and not technical point of view.

Contact Information
Charles Mulford. Invesco Chair, Professor of Accounting and the Lab's Director.
Phone: (404) 894-4395
Email: charles.mulford@mgt.gatech.edu

Michael L. Ely. MBA, Financial Analyst.
Phone: (404) 894-9473
Email: michael.ely@mgt.gatech.edu
Kerianne Maloney. Graduate research assistant and MBA student.
Raul Quiroz. Graduate research assistant and MBA student.
Mario Martins. Graduate research assistant and MBA student.

Website: http://www.mgt.gatech.edu/finlab

Companies Named In This Report

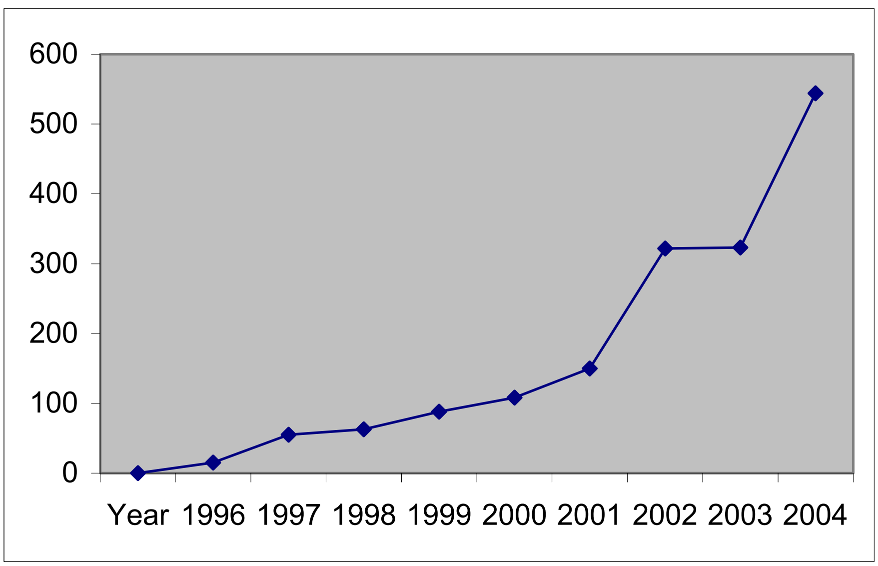
Free Cash Flow and Compensation: A Fashionable Fad or Something More?

Introduction

Cash flow in general and free cash flow in particular has always been of primary importance to investors. It is free cash flow that enables a firm to thrive and grow, allowing it to generate capital gains and pay dividends. However, such longstanding and fundamental importance of free cash flow notwithstanding, there has been a growing "discovery" of sorts of the measure by investors, analysts and the financial press. Consider, for example, Exhibit 1, where we graph references to free cash flow noted in the financial press for the period 1996 through early 2004.

Exhibit 1 References to Free Cash Flow in the Financial Press, January 1, 1996 – March 31, 2004, (2004 amount annualized).

Number of References to
"Free Cash Flow"
Appearing in the Financial Press by Year



Source: *The Wall Street Journal.Com*. A search was made for all references to "free cash flow" in *The Wall Street Journal, Barron's* and *Dow Jones Newswires* for each year, 1996 – 2003 and for the quarter ended March 31, 2004. References for the quarter ended March 31, 2004 were annualized.

In Exhibit 1 we graph the number of references to the term, "free cash flow" appearing in *The Wall Street Journal, Barron's* and *Dow Jones Newswires* for each year starting in 1996 and running through the quarter ended March 31, 2004. While these references included in-depth stories about free cash flow and how it was measured, most of them were short references to improvements or declines in free cash flow noted in company press releases or analyst reports. These announcements were then picked up by *Dow Jones Newswires* and included in our survey count.

As seen in Exhibit 1, a growing interest in free cash flow is unmistakable. In the financial press outlets we reviewed we found that during 1996 only fifteen references were made to free cash flow. There was a jump to 55 references in 1997 and a gradual upward trend to 108 references in 2000. After 2000, the number of references to free cash flow in the financial press increased dramatically each year to 322 in 2003. The increase continued during 2004, rising to 136 references during the first quarter ended March 31, 2004, which annualizes to a total of 544 references for the full year.

As another anecdotal example of a new-found interest in free cash flow, consider the following statement made in a comment about corporate strategy in the Management's Discussion and Analysis section of the annual report of Border's Group, Inc. for the year ended January 25, 2004, "The Company is continuing to implement its plan for the optimization of the Waldenbooks' store base in order to improve sales, net income and free cash flow."[1] However, in annual reports prior to 2002, the company's strategy statement made no reference to free cash flow. For example, in its annual report for the year ended January 28, 2001, the following statement on corporate strategy was made, "The Company's business strategy is to continue its growth and increase its profitability . . ."[2] There is certainly nothing wrong with growth and increased profitability. The two do not necessarily, however, provide free cash flow.

Amazon.com also appears to be a recent convert to free cash flow. As noted recently by a company spokesperson, "We think all the GAAP (generally accepted accounting principles) numbers are important, but the one management is most focused on is free cash flow."[3] This statement is consistent with the company's stated objective, which, according to its annual report is, ". . . long-term, sustainable growth in free cash flow."[4] But here again, the interest in free cash flow is of recent origin. The company did not mention free cash flow as part of its business objective in annual reports prior to the year ended December 31, 2001.

What we find remarkable about the new-found interest in free cash flow is that its importance to analysis and valuation is not new. The value of a share has always been the present value of the expected cash flows to which that share entitles its owner. So why are we now seeing such increased interest in free cash flow? We think that it is a natural reaction to the numerous and well-publicized accounting problems and examples of egregious acts of earnings management witnessed in recent years.

The accounting debacle we know as Enron Corp. occurred in 2001, the same year that interest in free cash flow began to increase dramatically. Certainly Enron Corp. was not the first accounting fraud of recent times. We had already seen serious accounting-rule violations and material restatements at such firms as Cendant Corp., Sunbeam Corp. and Xerox Corp. Enron, however, was a larger, more pervasive fraud in which a significant number of average people lost large amounts of money. Many of them lost their retirement plans and life savings. The story captured the attention of many as terms like accounting fraud and earnings management became part of our national lexicon.

Following Enron there was an extended period during which new accounting frauds seemed to be announced almost every day. Names like Dynegy, Inc., Adelphia Communications Corp., and certainly WorldCom, Inc. were constantly in the news. We almost began to expect "perp walks" as alleged perpetrators of accounting frauds were taken into justice.

To differing degrees each of the cases mentioned here along with many others entailed the reporting of fictitious earnings and restatements of prior-year amounts. Enforcement actions taken by the Securities and Exchange Commission against these firms and others often demonstrated the lengths to which managers would go in their quest to report fake profits.

Understandably, investors and analysts began to question earnings more than ever. They longed for something better, a metric upon which they could place more reliance and trust for purposes of analysis and valuation. Free cash flow was a natural candidate. It was viewed as an antidote of sorts to creative accounting and earnings management. It was somehow more pure, above the fray and immune to the problems besetting reported earnings.

Aware of the increased interest of analysts and investors in free cash flow, managers decided to provide them more of what they wanted. Free cash flow began to show up in places in which it had not been seen in the past. Beyond statements of corporate strategy, free cash flow began to show up in compensation agreements and in impairment tests of long-lived productive assets. Creditors also caught the fever and began to work free cash flow into certain loan covenants.

In this report we take a closer look at the use of free cash flow as a tool in compensation. While we did not have access to the details of corporate compensation agreements, we were able to identify numerous firms who had recently incorporated some measure of cash flow into their formula for compensation.

Incentive Compensation

Given the importance of free cash flow to valuation, it is no surprise that the measure has found its way into incentive compensation plans. By linking incentive pay to free cash flow, compensation agreements are better able to tie an individual manager's success to an important component of firm-wide success. Moreover, like sales growth, earnings growth, or return on equity, which are more traditional indicators of corporate achievement, a manager can be viewed as having more direct control over free cash flow than a firm's share price, for example.

Because shareholders are, for obvious reasons, very concerned about increases in a company's share price, price is often used as the basis for incentive compensation. For example, it is of paramount importance in stock option plans. If share price does not increase after the option grant date, most options will expire worthless. The premise of such plans is to tie the financial rewards of a company's management with the financial well being of its owners. The problem with these plans is that share price may move in a direction that is seemingly unrelated to a company's financial performance. Share price may linger or even decline for years even as managers are successful in boosting sales, earnings and cash flow. As a result, stock-related plans may not provide the kind of incentive that compensation committees seek.

While traditional financial measures such as sales growth, earnings growth and return on equity do reflect directly the efforts of management, the link between such measures and improvements in share price is not as compelling as the association between free cash flow and share price.

According to most valuation models, increases in free cash flow will translate directly into increases in share price. While an actual share-price response may be delayed due to other extraneous factors outside of management's control, for example, a rise in interest rates or a threat of increased terrorist activity, over time, a company's share price will respond.

Thus, free cash flow offers an incentive measure that can be linked directly to share price and reflects the efforts of management. Accordingly, it is a very compelling gauge upon which to base incentive compensation.

We surveyed corporate filings and found many examples of the use of cash flow in compensation agreements. The computations in some of the agreements referred to the use of cash flow in describing incentive compensation but provided no additional explanation. Others were a bit more descriptive and employed operating cash flow or cash provided by operating activities. In addition to these firms we did note several firms who referred to the use of free cash flow in their incentive compensation calculations.

The results of our survey are presented in three Exhibits. Exhibit 2 presents companies and references to incentive compensation agreements that used cash flow in their calculations without additional explanation. The companies in Exhibit 3 make reference to the use of *operating* cash flow in computing incentive compensation. Exhibit 4 presents those firms who made use of *free* cash flow in their incentive agreements.

Exhibit 2 Cash Flow Used in Calculating Incentive Compensation

Company	Reference to Cash Flow in Compensation Agreement
Newell Rubbermaid, Inc. (Form DEF 14A, March 26, 2004)	The Company's group presidents and other management level employees, including the Named Officers, are eligible to participate in the Company's Bonus Plan. In 2003, payments to participants were based on a combination of sales growth, operating income, *cash flow* and earnings per share.
Washington Post Co. (Form DEF 14A, March 23, 2003)	In the case of executive officers with responsibility for a particular business unit, such unit's financial results are also considered, including, depending on the business unit, revenue, operating income and *cash flow*.
Weyerhauser Co. (Form DEF 14A, March 10, 2004)	The restricted share program should utilize justifiable operational performance criteria combined with challenging performance benchmarks for each criterion (e.g., 10% annual increase in *cash flow*.)

Sources: Company filings with the Securities and Exchange Commission on the forms and dates indicated.

Exhibit 3 Operating Cash Flow Used in Calculating Incentive Compensation

Company	Reference to Cash Flow in Compensation Agreement
Comcast Corp. (Form 10-K, December 31, 2003)	"Quantitative Performance Standards" means performance standards such as income, expense, *operating cash flow*, numbers of customers or subscribers for various services and products offered by the Company or a division, customer service measurements and other objective financial or service-based standards relevant to the Company's business as may be established by the Committee.
General Electric Co. (Form DEF 14A, March 2, 2004)	125,000 of the performance share units will convert into shares of GE stock only if GE's *cash flow from operating activities* has grown an average of 10% or more per year during the five-year period from 2003 through 2007.
Nextel Communications, Inc. (Form DEF 14A, April 25, 2003)	The compensation committee has adopted a long term incentive plan intended to reward key members of Nextel's management for achieving specific performance goals relating to *operating cash flow* and net subscriber additions over a two-year period commencing January 1, 2002.

Sources: Company filings with the Securities and Exchange Commission on the forms and dates indicated.

Exhibit 4 Free Cash Flow Used in Calculating Incentive Compensation

Company	Reference to Free Cash Flow in Compensation Agreement
American Standard Cos., Inc. (Form 8-K, January 26, 2004)	Each year we establish an operating plan that sets goals for overall corporate and operating unit performance with specific financial and strategic measures. In 2003, these included sales growth, earnings per share, *free cash flow*, as well as individual goals.
Bausch & Lomb, Inc. (Form DEF 14A, March 25, 2004)	Operating unit performance is measured against targets established for sales, earnings, *free cash flow*, cost improvement initiatives, and strategic projects, tying incentive compensation to key shareholder return indicators.
Kraft Foods, Inc. Form DEF 14A, March 5, 2004)	In determining . . . compensation, the Committee considered individual performance with respect to the achievement of key strategic, financial, and leadership development objectives, including income growth, volume growth, productivity savings, new product development, increasing market share and increasing *free cash flow*.
Motorola, Inc. (Form DEF 14A, March 12, 2004)	The Motorola Incentive Plan (MIP) . . . focuses on operating earnings (OE) and *free cash flow*, two measures critical to improving shareholder returns. OE and *free cash flow* targets are established for the Company and each of its major sectors. While most employees are rewarded based on sector performance, high-level elected officers (including the executives named in the Summary Compensation Table) have a significant portion of their award based on the OE and cash flow of the entire Company.
Tyco International, Ltd. (Form DEF 14A Jan. 28, 2004)	Annual incentive bonus opportunities for segment presidents . . . were based upon the Compensation Committee's and senior management's assessment of the respective segment's financial performance, evaluated using earnings before interest and taxes ("EBIT") and Segment *Free Cash Flow*, with a portion of the annual incentive bonus based on the overall performance of Tyco, using Earnings Per Share ("EPS") and total Company *Free Cash Flow* as the measures.

Sources: Company filings with the Securities and Exchange Commission on the forms and dates indicated.

In Exhibit 2 we list three firms who made reference to the use of cash flow in their compensation agreements but who provided no clarification of what specific cash flow amount was being measured. One can only wonder how the so-called cash flow measure was calculated and whether the intent was to focus on another measure, such as operating cash flow or free cash flow. Two of the three firms made reference to other, more traditional measures of financial performance in their compensation agreements. For example, Newell Rubbermaid, Inc. noted that bonuses were based on growth in sales, operating income, cash flow and earnings per share. Washington Post Co. also made reference to revenue, operating income and cash flow. Weyerhauser Co. mentioned only that it used "challenging performance benchmarks," for which it provided 10% annual increase in cash flow as an example.

The firms listed in Exhibit 3 made use of the more descriptive operating cash flow in their compensation agreements. For example, Nextel Communications, Inc. based its performance goals on increases in operating cash flow and subscribers over a two-year period. General Electric Co. is included in this list. The company's description of how it uses operating cash flow in computing incentive compensation is rather pointed. According to the company, certain performance share units will convert into shares of stock in GE if GE's cash flow from operating activities, ". . .increases an average of ten percent or more per year during the five-year period from 2003 through 2007."[5]

In Exhibit 4 we see a list of firms who made reference to free cash flow in their compensation agreements. Most of the firms listed included free cash flow along with other, more traditional measures of financial performance. Often, the use of these measures was defended because of their perceived link to shareholder returns. For example, Bausch & Lomb, Inc. noted that free cash flow, as well as sales and earnings among other measures, were used because they represent key shareholder return indicators. Motorola, Inc. indicated that it focused on operating earnings and free cash flow because the two measures were considered critical to improving shareholder returns.

Cash Flow and Compensation: A Recent Development

We examined further the filings of the company's included in Exhibits 2, 3 and 4 for the years 2000, 2001, 2002 and 2003. Our interest was in determining whether the interest in measures of cash flow is of recent vintage.

What we found is that the use of cash flow in compensation agreements is a recent development. Most of the companies in our survey announced that they were adding some measure of cash flow to their compensation arrangements in 2001. For example, prior to 2002 Motorola, Inc., did not use free cash flow, or certainly did not mention the use of free cash flow in its public disclosures, for purposes of measuring incentive compensation. American Standard Cos. noted in its proxy statement dated March 30, 2001 that it had revised its long-term performance criteria to include free cash flow. GE's explicit reference to growth in cash flow from operating activities that averages ten percent or more also occurred since 2001. However, for several years prior to that the company did mention in general terms the importance of improving cash flow as a goal in determining compensation.

Creative Cash Flow Reporting and Incentive Compensation

As presented in Exhibits 2, 3 and 4, we saw many examples of companies who employed various measures of cash flow, including free cash flow, for the purpose of computing incentive compensation. While cash flow appears to provide a sensible measure upon which to base incentives, we wonder whether adjustments are being made to cash flow before incentives are computed.

For example, would managers earn a bonus if operating cash flow and correspondingly free cash flow were increased because management delayed the payment of vendor payables? What if free cash flow were increased because receivables were sold through a securitization agreement? A reclassification of investments to a trading designation would also boost free cash flow when the investments were sold. Would cash flow provided in this manner result in an increase in incentive compensation?

We do not think that nonrecurring cash flow provided through creative means, whether within or beyond the boundaries of generally accepted accounting principles, should provide the basis for increased compensation. However, as we reported in numerous studies published by our Lab, cash flow is very open to so-called creative reporting. Accordingly, there is a risk that managers may employ such practices to increase free cash flow when corporate performance has not really improved.

We were not privy to the detailed computations of incentive compensation based on cash flow and whether adjustments were made for nonrecurring cash flow created through such means. We did note that in the case of GE, operating cash flow was, "adjusted to exclude the effect of unusual events."[6] However, what constituted such unusual events was not described.

Conclusion

With the increased interest in free cash flow, companies have begun to incorporate measures of cash flow into compensation agreements. Unfortunately, as readers of the reports posted on our web site know, free cash flow is not above the creative-accounting fray. In fact, arguably it is easier to manipulate operating cash flow within the boundaries of GAAP and correspondingly manipulate free cash flow, than it is to manipulate earnings. Still, we welcome the new found attention being given to free cash flow because it is so fundamental to what ultimately matters to investment analysis. What remains to be seen and provides an open question for which we have no answer at present is whether the increased attention on free cash flow will be nothing more than a fashionable but passing fad or whether the attention on it will be longer lasting. If investors begin to believe that free cash flow is being creatively managed to amounts that do not reflect true economic performance then we feel that interest in it will wane. Stay tuned.

---

[1] Borders Group, Inc., Form 10-K annual report to the Securities and Exchange Commission, January 27, 2004, p. 16.

[2] Border's Group, Inc., Form 10-K annual report to the Securities and Exchange Commission, January 28, 2001, p. 13.

[3] B. Curry, a spokesperson for Amazon.Com, Inc., as quoted by N. Wingfield, "Options Move May be at Expense of Accounting Purists." *The Wall Street Journal,* July 14, 2003, p. C1.

[4] Amazon.Com, Inc., Form 10-K annual report to the Securities and Exchange Commission, December 31, 2003, p. 22.
[5] General Electric Co., Form DEF 14A, definitive proxy statement filed with the Securities and Exchange Commission, March 2, 2004, p. 22.
[6] Ibid.