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How to calculate total cash flow from operating activities

7 Min. Read June 21, 2021 The net cash flow formula helps reveal if a business is performing well or in danger of going bankrupt. Repeated periods of positive net cash flow are a good sign that your business is ready to expand, whereas repeated periods of negative net cash flow can be a sign that your business is struggling. This guide will give you an in-depth understanding of net cash flow and how to calculate it using the net cash flow formula. Here's What We'll Cover: What is Net Cash Flow? What is the Net Cash Flow Formula? Why Net Cash Flow is Important Limitations of Net Cash Flow Is Net Cash Flow the Same As Net Income? Key Takeaways More Resources on Small Business Accounting What is Net Cash Flow? Net cash flow (NCF) is a metric that tells you whether more cash came in or went out of a business within a specific period of time. If more cash came in, the result would be a positive cash flow. Whereas if more money went out, the result would be a negative cash flow. You'd calculate the NCF by looking at your cash flow statement, particularly the three cash flow categories (Operating Activities, Investing Activities, and Financing Activities.) What is the Net Cash Flow Formula? Put simply, NCF is a business's total cash inflow minus the total cash outflow over a particular period. $NCF = \text{total cash inflow} - \text{total cash outflow}$ An extended formula is: $NCF = \text{Net cash flows from operating activities} + \text{Net cash flows from investing activities} + \text{Net cash flows from financial activities}$ Net cash flows from operating activities: Examples of cash flow in net operating activities include the change in net income for the period as well as the adjustments to reconcile net cash provided by or used in operating activities, to name a few. Net cash flows from investing activities: Some examples of cash inflows from investing activities include the sale of investment properties or securities. Examples of cash outflows are capital expenditures (i.e., purchase of fixed assets). Net cash flows from financial activities: Some examples of inflows of financing activities are proceeds from a loan to finance the business and examples of outflows are repayments of the loan. Net Cash Flow Example Josh from Company ABC is trying to determine the NCF of his business over the last month. When he looks at the statement of cash flow, he sees the following: Cash flow from operations: \$50,000 Cash flow from investing: (\$70,000) Cash flow from financing: \$15,000 To calculate NCF for the month, he'd do the following calculation: $NCF = \$50,000 + (-\$70,000) + \$15,000$ The NCF for the specific period would be a negative cash flow of \$5,000. Although one period of negative cash flow isn't necessarily a bad sign, Josh would want to ensure this doesn't repeatedly happen period over period. What is the Operating Cash Flow (OCF) Formula? Investors and analysts particularly pay attention to the cash flow from operating activities because this reveals a business's ability to make a profit from core operations. If investing and financing continually produce a significant cash flow, but cash flow from operations are continually in the negative, this can be a red flag. The most common way to calculate operating cash flow is through the indirect method, which takes into account the net income under an accrual basis of accounting. $OCF = \text{Net Income} + \text{Non-Cash Expenses} +/ - \text{Changes in Working Capital}$ Using this method, you start with the net income (taken from the bottom of the income statement) and work backward to determine the operating cash flow. Let's breakdown the equation: Net income: The net income is the starting point of your OCF calculations. Changes in working capital: Working capital equals current assets minus current liabilities. Net income factors in current assets (accounts receivable, inventory, etc.) and current liabilities (such as accounts payable), whereas cash flow does not. This is why adjustments to the net income account for changes in working capital. Non-cash expenses: Non-cash items, including depreciation, amortization, and stock-based compensation, are expenses created by accounting principles. In other words, they don't actually involve a cash payment, so although the net income includes these expenses, OCF does not. Why Net Cash Flow is Important NCF gives a business owner and potential investors insight into the financial health of a business. Having negative cash flow for many consecutive months can be a sign that your business is in trouble. On the other hand, consecutive months with positive cash flow can be a sign that your business is thriving. Positive Cash Flow Positive NCF opens up many opportunities for a business, such as the ability to invest in research and development, new equipment, and hire more employees. Negative Cash Flow Negative NCF limits a business's ability to invest back in the business. Consequently, business owners must figure out ways to improve cash flow through means such as discounts for upfront payments, chasing late payments, or through loans. NCF also helps business owners make decisions about the future and is particularly important when calculating the payback period of a potential investment. Limitations of Net Cash Flow In isolation, NCF does not tell the full story. The reasons behind a negative NCF can sometimes be positive for the business. For example, a few consecutive months of negative cash flow can result from paying off large amounts of debt. Conversely, a positive NCF can simply be the result of receiving a \$5,000 loan, which is a lot different from a positive cash flow from making a \$5,000 sale. Another limitation of NCF is that even if a business makes a capital investment that'll bring a substantial return on investment in the future, the NCF would still show negative for the specific time period. This is why it's important to consider the NCF of periods over periods. Another way to overcome this limitation is to consider other formulas in tandem with NCF (such as free cash flow). Is Net Cash Flow the Same As Net Income? No, your business can have a high net income, but a negative cash flow. One way this can happen is if many of your customers are on lengthy payment plans or if you allow clients to pay you months after a service is performed. This is because net income generally considers accounts receivable, but NCF doesn't. Let's say you made a sale for \$9,000, but the customer only pays you \$3,000 today and \$6,000 over the next two months. Your cash flow from the sale will only be \$3,000 this month, whereas your net income would factor in the entire \$9,000, even though you haven't technically received it yet. Key Takeaways The net cash flow formula gives you key insight into how your business is doing. However, a period of negative cash flow isn't necessarily a bad thing, just like a period of positive cash flow isn't necessarily a good thing. Period over period of negative cash flow should be addressed by following simple cash flow management tips. Manage cash flow to grow your business faster! More Resources on Small Business Accounting What Is Cash Basis Accounting? What Is Accrual Basis Accounting? RELATED ARTICLES Cash flow from operating activities is an essential part of your company's cash flow statement. In addition, understanding cash flow from operating activities can give you some excellent insights into the viability of your core business activities. So, what is cash flow from operating activities and how can you calculate it? Find out everything you need to know with our definitive guide Cash flow from operating activities explained Cash flow from operating activities (CFO) - also referred to as operating cash flow, free cash flow from operations, or cash flow provided by operations - indicates how much money a business is bringing in from regular business activities. It does not include long-term capital expenditures, revenue from investments, or expenses. Put simply, it is a metric that's solely focused on your core business activities. Cash flow from operating activities formula The exact formula you use to work out cash flow from operating activities will differ from company to company. This is because every business has different items on their balance sheet/income statement. Having said that, there is a general cash flow from operating activities formula that you can use if you're not sure where to start. $\text{Cash Flow from Operating Activities} = \text{Net Income} + \text{Non-Cash Items} + \text{Changes in Working Capital}$ While you can find the figure for net income on the income statement, you'll need to do a little more digging for non-cash items. This includes a wide range of expenses, including depreciation, amortization, depletion, stock-based compensation, and more. After you've added non-cash items to net income, you'll need to add in your company's net changes in working capital. Examples of cash flow from operating activities Let's look at how to use the cash flow from operating activities formula in the real world. Imagine Company A has a net income of £1,500,000 and a net change in working capital of £900,000. Furthermore, Company A's depreciation, amortisation, depletion, and other non-cash expenses total £400,000. Using these figures, you can work out the total like so: $\text{Cash Flow from Operating Activities} = £1,500,000 + £400,000 + £900,000 = £2,800,000$ Cash flow from operating activities format: direct and indirect It's important to understand that there are two main ways to calculate cash flow from operating activities on the cash flow statement: direct and indirect. In the "direct method," your operating cash flows are entered as a list of outgoing and ingoing cash flows. However, in the "indirect method," operating cash flows are shown as a reconciliation from profit to cash flow. So, how do you display cash flow from operating activities with each of these methods? Cash flow from operating activities - direct method: With the direct method, you'll record all your transactions and display the information using actual cash inflows/outflows. Cash flow from operating activities - indirect method: With the indirect method, you'll need to start with net income and work backward to achieve a figure for cash basis, applying adjustments for amortization and depreciation (i.e. non-cash items). Why is cash flow from operating activities important? The cash flow from operating activities formula shows you the success (or not) of your core business activities. If your business has a positive cash flow from operating activities, you may be able to fund growth projects, launch new products, pay dividends, reduce the company's debt, and so on. You should also remember that investors will often specifically look for companies with an upwardly trending cash flow from operating activities. We can help GoCardless helps you automate payment collection, cutting down on the amount of admin your team needs to deal with when chasing invoices. Find out how GoCardless can help you with ad hoc payments or recurring payments. 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