

What Is Cash Flow? Definition And Strategies To Improve It



Cash flow refers to the increase or decrease in the amount of money an organization or person has at any given point.

In the world of finance, the term is used to describe the amount of cash that is generated or expended within the accounting period. There are multiple types of cash flow. All of them play an important role in operating a business and performing regular financial analysis.

Cash that comes into the business is called cash inflows. Cash that leaves the business is called cash outflows. You report your cash flow on the cash flow statement. Small businesses must keep an eye on this to make sure they have enough cash and working capital to cover everything.

This often means striking a balance between accounts payable and accounts receivable so they have more money coming in than going out at any given time.

Think of it like this:

You get paid every two weeks, and you make enough money to pay your bills, with a little extra leftover. That little bit leftover is your cash flow, that will make it possible for you to live comfortably and spend money as needed until you get paid

again.

Now, imagine your car breaks down and costs more than you had left after your bills are paid.

If you have money in savings, you can withdraw it to keep yourself cash flow positive until you get paid again.

If you don't have money in savings, you're cash flow negative. (And even if you did have money in savings, if it wasn't enough to cover the expense of the repair, you're still cash flow negative.)

Using a credit card or personal loan from your family to pay your car repair bill keeps you operating - but you're still cash flow negative until you get paid again. And then, you'll have the expense of paying back the loan or credit card balance.

It's not just businesses that struggle with cash flow. Individuals just don't have cash flow statements to help them see what their finances really look like.

Types of Cash Flow

There's more than one type of cash flow. To be successful in business, it's important to understand what each of them is.

All of them can be used in cash flow analysis, though most looking at financial health focus on actual cash, and cash from business operations.

Cash from Operating Activities

Also known as operating cash flow or cash flows from operations (CFO), this is the cash a company generates from its core business activities.

This doesn't include cash flow from investing. You can find it in the first section of the cash flow statement.

Cash Flows from Investing (CFI)

Also known as investing cash flow, this indicates how much cash a business spends or generates from its investing activities over a specific period of time.

Cash Flows from Financing (CFF)

The financing cash flow indicates net cash flows used to fund the company and its capital.

If the company is running solely on investment funds or loans, it's not a good sign - unless the product or main source of revenue has yet to go to the market. CFF gives investors a better look at a company's financing activities, financial strength, and how well it manages its capital structure.

Free Cash Flow to Equity (FCFE)

This number represents the available cash after capital expenditures and operating expenses.

Free cash flow helps analysts to determine how profitable a company could be.

Free Cash Flow to the Firm (FCFF)

Under this measure, it's assumed the company has no debt (also known as leverage.)

This type of cash flow is most often used in valuation and financial modeling. Lenders pay attention to this when deciding whether to take a risk with a business.

Net Change in Cash

This is the change in the amount of cash flow from one accounting period to the next. It can be found at the bottom of the cash flow statement. You may see it referred to as a net change in cash and cash equivalents.

If you want to see how healthy a business is, look at the net change in cash for the given period, as well as the one before it.

How to Use Cash Flow

Cash flow has many uses within a company, aside from financial analysis. It is one of the most crucial metrics in all of accounting and finance.

Let's take a closer look at some of the most common cash metrics and uses of cash flow.

- **Capital Expenditures:** Businesses can fund money back into the business to fund its growth.
- **Cash Conversion Ratio:** This is the amount of time between when a business pays the cost of goods sold (COGS) and receives payment from its customers.
- **Cash Flow Per Share (CFPS):** This is the operating cash flow divided by the number of outstanding shares.
- **Cash Flow Risk:** A term that describes the potential of a business not being able to meet its obligations at the time they come due.
- **Cash Flow Yield:** This is a measure of how much cash a business brings in per share, compared to its share price. It's expressed as a percentage.
- **Dividend Payments:** Businesses can use cash flow to fund dividend payments to investors.
- **Funding Gap:** This is a measure of a shortfall the company must overcome; how much more cash it needs to accomplish a task - be it paying a bill, funding an expansion, or purchasing equipment.
- **Internal Rate of Return:** Cash flow is used to determine the rate of return an investor gets for making an investment.
- **Liquidity:** This is a measure of how well a company can meet short-term financial obligations. Do they have cash on hand? Or will they have to sell all their equipment before they can meet them?
- **Net Present Value:** Here, cash flow helps to calculate the value of a business by buying a DCF model and calculating the Net Present Value, or NPV. NPV refers to the value of all future cash flows (both positive and negative) over the full life of an investment, discounted to the present.
- **P/CF Ratio:** This is the price of a stock divided by the CFPS. This calculator is sometimes used as an alternative to the Price-Earnings (P/E) ratio.

Cash Flow vs. Income

Cash flow provides a more accurate picture of how well a business is really doing, whereas income looks solely at the revenue a company generates. If you make \$1,000,000, at first glance, your company looks like it's doing well.

But, if you had to spend \$1.5 million to do it, then you lost money.

And you may have had adequate cash flow the whole time - because you had investors and loans to fund the difference. it's also possible that you ran into a negative cash flow issue a few times but were able to figure it out to keep things moving.

Cash Flow vs. Profit

Cash flow isn't the same as profit, either. Take, for instance, the above example. If you report \$1 million in revenue but spent \$1.5 million, then you have a loss of \$500,000.

That means you made no profit, despite bringing in a million dollars of revenue.

Profit is a measure of the extra money your company earns after paying all of its expenses. If you spend more money than you bring in, you will not have a profit.

But, again, if you have the funds coming from loans and investors to cover your expenses, you can still have a positive cash flow even though you don't have any profit.

Cash Flow Statement

The cash flow statement may also be referred to as the statement of cash flows. It is one of three important financial statements.

The other two are the balance sheet and income statement. The balance sheet gives investors a look at assets and liabilities for that particular period. The income statement shows the business's profitability for that particular accounting period.

The cash flow statement, however, is different from the others. It functions as a corporate checkbook of sorts.

It gives a clearer picture of a company's financial activities - listing all the cash transactions (inflows and outflows) - for all the given accounting period. It demonstrates whether all the revenue listed on the income statement has been collected.

The cash flow may not show all the company's expenses, though, since not all expenses a company incurs are paid right away. Though the company may have incurred liabilities, the payments toward those liabilities aren't recorded as a cash outflow until the transaction takes place.

Cash flow is a business's life force. Without it, the business will ultimately (yet likely not immediately) fail.

Ways to Improve Cash Flow

Improving cash flow can be done in multiple ways, across multiple areas of your business. Because cash flow matters so much to a business, it's important to take steps to improve it when and wherever possible.

You never want to be left in a situation where you cannot pay a supplier because you're waiting on payments to come in from a customer.

Revenue Growth

Within revenue growth, there are two distinct areas you can focus on volume and price.

Volume

- Bringing in more customers
- Getting more return customers
- Referrals
- Marketing leads

Price

- Add new items at a higher price
- Charge a higher price for existing items

Operating Margin

Within the operating margin, you can focus on the COGS and selling, general & administrative expenses (SG&A).

COGS

- Negotiate better deals with suppliers
- Start using automation
- Implement a return management strategy

SG&A

- Adjust your marketing budget
- Reduce payroll expenses
- Reduce overhead expenses
- Reduce shipping costs

Capital Efficiency

Within capital efficiency, you can focus on property, plant, and equipment (PP&E), and inventory.

PP&E

- Find ways to earn a higher return on assets
- Make use of proprietary technology

Inventory

- Increase inventory turnover rate
- Implement better inventory management
- Increase buying efficiency

If your business isn't cash flow positive right now, it may not mean impending doom.

But, if you don't take action to save money and find ways to improve the cash flow, you're only setting yourself up for more trouble later.

What's your goal today?

1. Use PLANERGY to manage purchasing and accounts payable

We've helped save billions of dollars for our clients through better spend management, process automation in purchasing and finance, and reducing financial risks. To discover how we can help grow your business:

- Read our case studies, client success stories, and testimonials.
- Visit our "Solutions" page to see the areas of your business we can help improve to see if we're a good fit for each other.
- Learn about us, and our long history of helping companies just like yours.

[Book a Live Demo](#)

2. Download our guide "Preparing Your AP Department For The Future"

Download a free copy of our guide to future proofing your accounts payable department. You'll also be subscribed to our email newsletter and notified about new articles or if have something interesting to share.

[download a free copy of our guide](#)

3. Learn best practices for purchasing, finance, and more

Browse hundreds of articles, containing an amazing number of useful tools, techniques, and best practices. Many readers tell us they would have paid consultants for the advice in these articles.

Related Posts