# What Is Operating Cash Flow?

Operating cash flow, known as OCF, is a way to measure the amount of money generated by a company's normal business operations.

An organization's operating cash flow serves as an indication of whether a company can generate enough cash to maintain itself and grow.

Otherwise, it may have to turn to outside sources of capital to finance operations and growth.

## Understanding Operating Cash Flow

OCF represents the cash impact of a company's net income (NI) from its main activities. You may also hear OCF referred to as "cash flow from operating activities." It is presented on the cash flow statement.

According to the generally accepted accounting principles or GAAP, there are two methods of presenting operating cash flow section.

These are known as the indirect method and the direct method. If a company chooses to use the direct method, the company must still perform a separate reconciliation similar to the way they would with the indirect method.

Cash flow from operating activities (CFO) indicates how much money a company brings from ongoing, regular, activities. It does not include any long-term capital expenditures or investment revenue and expenses. It focuses solely on the core business.

## The Indirect Method of Cash Flow Calculation

Using the indirect method a company begins with their net income on an accrual accounting basis and works backward to achieve a cash basis figure for the accounting period.

Using the accrual method of accounting, revenue is organized when it is earned not necessarily when the money is actually received.

For instance, consider a manufacturing company that reports a net income of $100 million while its operating cash flow is $150 million. The difference results from the depreciation expense of $150 million, an increase in accounts receivable of $50 million, a decrease in accounts payable of $50 million. It would appear on the operating cash flow section of the cash flow statement like this:

- Net Income $100 million
- Depreciation Expense +$150 million
- Increase in AR -$50 million
- Decrease in AP -$50 million
- Operating Cash Flow $150 million

All non-cash items are added back, reversing any accruals such as:

- Depreciation – the accounting method for expensing property, plant, and equipment (PP&E) purchase
- Stock-based compensation not paid out with cash, but compensation that is paid out through the issuance of additional shares
- Other expenses/income – includes a variety of items like accrued items, or unrealized losses or gains.

Then, you factor in the change in working capital – operating assets and liabilities. These adjustments include:

- Inventory on the balance sheet goes up – there’s a reduction of cash. If it

goes down, there's usually an increase in cash. (Not always true, as you may have to write off some inventory as lost, stolen, or damaged. These items won't result in sales.)
- Increases in accounts receivable – this reduces cash too because a position of revenue hasn't yet been paid by your customers.
- When accounts payable, accrued expenses, and unearned revenues increase, there is a subsequent increase in cash.

## The Direct Method of Cash Flow Calculation

With the Direct Method, a company records all transactions on a cash basis and then displays the information with actual cash inflows and outflows that occur during the accounting period.

Examples of the direct method of operating cash flow include things such as:

- Cash collected from customers
- Cash paid to vendors and suppliers
- Salaries and wages paid out to employees
- Interest income and dividends received
- Income tax paid and interest paid

> *Positive cash flow is a good thing, as it means the core business activities are producing enough revenue to keep the company moving foward.*

# How to Calculate Operating Cash Flow

With the indirect method, net income is adjusted to a cash basis, based on changes in non-cash accounts like accounts payable, accounts receivable, and depreciation.

Since the majority of companies report net income on an accrual basis, several non-cash items are included like amortization and depreciation.

# The Operating Cash Flow Formula

The short form of Operating Cash Flow formula:

Operating Cash Flow = Operating Income + Depreciation – Taxes + Change in Working Capital or

Operating Cash Flow – Net Income + Non Cash Expenses – Increase in Working Capital

The long form of Operating Cash Flow formula:

Operating Cash Flow = Net Income + Depreciation + Stock Based Compensation + Deferred Tax + Other Non Cash Items – Increase in Accounts Receivable – Increase in Inventory + Increase in Accounts Payable + Increase in Accrued Expenses + Increase in Deferred Revenue

# The Three Types of Cash Flows

There are three types of cash flows in a business:

## Operating

Operating cash flow includes all cash (revenue) a company's main business activities generate.

## Investing

Investing cash flow includes all capital asset purchases, along with investments in other business ventures.

## Financing

Financing cash flow includes all the proceeds a business gains from issuing debt and equity, along with any payments the company makes.

## Why is Operating Cash Flow So Important?

Sometimes, financial analysts will opt to look at cash flow metrics because the numbers are clearer.

Looking at other parts of the financials muddies the waters because of certain accounting anomalies. The operating cash flow, on the other hand, gives a fairly

accurate picture of the current state of business operations.

For instance, when you book a big client, you'll get a big boost to revenue. But, if your company is having a hard time collecting the payment, then there isn't really an economic benefit for the company.

On the flip side, if a company has a high operating cash flow, but is reporting a low net income, that's likely because there are a lot of fixed assets with accelerated depreciation calculations.

If a company isn't bringing in enough money from its core business operations, it has to find temporary sources of external funding through investing or financing.

But this is unsustainable in the long run; operating cash flow is an important number to help assess the financial stability of a company's operations.

Operating cash flow affects the company's liquidity, so it is highly significant for a number of reasons. It allows business operators and owners to check where the money is coming from and where the money is going.

It can help them take action to generate and maintain enough cash flow for operations and other needs. Because of this, it can help in making many key financial decisions.

When a business has plenty of cash available, it's easy to expand, build, and launch new products.

They can also buy back shares from investors to strengthen their overall financial position, payout dividends to shareholders to boost confidence, or pay down debt to save money on interest.

For companies looking for investors, it's important to know investors generally look for companies that have lower share prices, but the operating cash flow has shown an upward trend over the past few quarters.

This disparity indicates that the company is increasing its cash flow level, which when better utilized can increase share prices in the near future.

This metric is an indication as to whether an organization can generate sufficient funds to maintain and grow operations.

If not, external financing is required. If the company goes too long with a negative operating cash flow, it may have to close its doors.

But, if the company gets and stays positive with that number growing consistently over several quarters, it is an indication that the company has a high potential for profitability.

# Performing Financial Analysis

If you're looking to put together a financial analysis of your company, or want to see a financial analysis for investment purposes, you should always use operating cash flow in conjunction with free cash flow (FCF), net income, and other metrics so that you can get a clear picture of the company's financial health and performance.

Pay close attention to all the details on the financial statements, including current liabilities, financing activities, operating expenses, and so on. The statement of cash flow is only one aspect of a company's cash flow and reserve.

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