ACCOUNTING

Understanding free cash flow

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If you want to determine how much liquid money you have to invest in growing your business or paying down debt, you'll need to grasp the concept of free cash flow.

Free cash flow is a term that may be new to you as a small business owner. But it's a crucial indicator of your business's financial health, one that can be essential if you seek partners or investors. That's why, for smart business owners looking to grow their enterprises, understanding the ins and outs of free cash flow is of vital importance.

What is free cash flow?

Free cash flow, or FCF, is the money that is left over after a business pays its

operating expenses (OpEx), such as mortgage or rent, payroll, property taxes and inventory costs — and capital expenditures (CapEx). Examples of CapEx are long-term investments such as equipment, technology and real estate. Technically, free cash flow is a key measure of profitability that excludes non-cash expenses (depreciation, for example) listed on the business's income statement. It includes spending on balance sheet items like equipment and changes in working capital — the money you have available to meet short-term obligations. Ultimately, free cash flow can be used to invest in growing the business, paying down debt or paying dividends to owners and shareholders.

How free cash flow is calculated

Technically, a business's free cash flow can't be found on any of its financial statements. Plus, there are no regulatory standards mandating how to calculate it. In general, the formula involves calculating what's left after a company pays both its operating expenses and capital expenditures.

More specifically, there are two main approaches to doing the calculation.

Revenue approach

Start by adding up revenues you've received, then subtract cash expenses, payments for interest on loans and taxes, and purchases of equipment or other big items you plan to depreciate.

Net profit approach

Start with your net profit (a measure of the profitability of your business after accounting for costs and taxes), then add non-cash items. After that, subtract interest payments and large purchases.

The final answer for both methods should be the same, but your accountant might prefer one over the other.

Why free cash flow is important

The “free” in free cash flow means how much a business has in its coffers to spend. Considered a reliable measure of business performance, free cash flow provides a glimpse of how much cash your business really has to draw on. A healthy, positive free cash flow indicates the business has plenty of cash left over. On the other hand, when it’s negative, that means your enterprise isn’t producing enough cash to support the growth of the business.

The upshot: Positive free cash flow means you have sufficient money to invest back into the business for growth or to distribute to shareholders. Negative free cash flow could portend that you’ll need to raise money to pay the rent or there’s a potential for healthier competitors to outperform you in the market.

The power of free cash flow

Healthy free cash flow will allow you to invest in the growth of your business and reduce debt. Here are five common uses of free cash flow in a small business:

- Hiring more employees
- Repaying creditors
- Acquiring another business
- Opening another office
- Paying dividends to owners and shareholders

Additional insights found from calculating free cash flow

An assessment of your free cash flow can provide insights into both your business's value and trends in fundamentals. Take your accounts payable and accounts receivable, for example. A reduction in accounts payable could indicate suppliers are demanding faster payment, while a drop in receivables collected could mean your business is collecting payments owed to you more quickly than before.

You can also get a more nuanced picture of your working capital from free cash flow than an income statement generally provides. Consider a business consistently making a healthy net income over multiple years, as reflected on its income

statement. At first glance, that might indicate an overall positive situation. However, a closer look at the cash flow numbers might reveal a problem that wouldn't otherwise have been apparent — perhaps a confluence of troubling factors, such as a rise in unsold goods, delayed customer payments and demands from suppliers for speedier accounts payable. With such insights, you can make more informed decisions about your business.

How to improve free cash flow

The amount of free cash flow a business has at its disposal isn't a static number. In some businesses, it's highly changeable. In any case, there are steps you can take to improve how much free cash flow you have on hand. For starters, consider introducing systems for better tracking payments and expenses. You also might restructure your debt to lower the interest rate you're charged or arrange better repayment schedules. Or you can reduce or delay capital purchases. Another idea: Hire a chief financial officer (CFO) who can help you with your financial strategy and operations. Many small businesses can't afford to hire a full-time CFO and turn to "fractional" CFOs — freelancers who work for them part time.

In some cases where there's negative free cash flow, you might need to take more aggressive steps, like restructuring your operations.

Ultimately, by understanding the state of your business's free cash flow and tracking it on an ongoing basis, you can position your business for the future, making investments that drive growth and reduce debt.