Free Cash Flow – What Does It Mean for Business Growth?

6 min read

Those familiar with the term "free cash flow," have typically encountered it in use with regard to investing.

Key Takeaways

- **Free Cash Flow In Your Business:** Free cash flow is the amount of cash (operating cash flow) which remains in a business after all expenditures (debts, expenses, employees, fixed assets…
- **Free Cash Flow Compared to Other Valuation Metrics:** This metric is basically free cash flow adjusted for debt. FCFE measures the equity value of a company, in other words the amount of money available to…
- **Enhance Your Free Cash Flow With GrowthForce Outsourced Accounting Services:** Outsourced accounting can significantly enhance your free cash flow by streamlining financial processes and optimizing resource allocation…

Free cash flow, however, is also **an integral measurement tool in management accounting**. This metric allows business owners, managers and board members to measure and monitor a company's present value to track growth, encourage expansion and avoid failure.

What Is Free Cash Flow In Your Business?

The simplest definition of free cash flow is the amount of leftover money in a company. Free cash flow is the amount of cash (operating cash flow) which remains in a business after all expenditures (debts, expenses, employees, fixed assets, plant, rent etc.) have been paid. Free cash flow represents a company's current cash value (not considering growth potential).

Cash Flow Versus Free Cash Flow – How Are They Different?

Although they sound similar, the two are quite different.

- Cash flow is the flow of cash coming in and going out of a business over a certain period of time. It is presented in a cash flow statement.
- **Free cash flow** represents the **amount of disposable cash in a business** (remaining after all expenditures). Sometimes, free cash flow is considered to be a company's current cash value. Though, since it does not take into consideration a business's growth potential, it is not normally considered a business valuation.

How to Calculate Your Company's Free Cash Flow

Free cash flow (FCF) equals cash from operations (CFO) minus capital expenditures (CapEx).

FCF = CFO – CapEx

Although the equation appears simple, free cash flow can be a daunting metric to calculate because you must first calculate your company's cash from operations and determine its capital expenditures, using information from your company's balance sheet and/or cash flow statement.

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Cash from Operations

First, you must determine your company's cash from operations.

CFO = Net Income + Non-Cash Expenses +/– Change in Non-Cash Net Working Capital

Non-Cash Expenses

These are all of the items (adjustments) on an income statement which do not actually affect cash.

Non-Cash Expenses = Depreciation + Amortization + Gains/Losses on Investments + Stock-Based Compensation + Impairment Charges

Change in Non-Cash Net Working Capital

Accurately calculating this change can be tough. Accounts receivable (AR), accounts payable (AP) and inventory are the three items which most commonly affect fluctuations in net working capital.

Change in Non-Cash Net Working Capital = (Current Period AR – Prior Period AR) + (Current Period Inventory – Prior Period Inventory) – (Current Period AP – Prior Period AP)

Capital Expenditures

Finally, you must determine the company's capital expenditures. You can do so with line items (Property, Plant and Equipment (PP&E), depreciation and amortization) from the company's balance sheet.

CapEx = Current Period PP&E – Prior Period PP&E + Depreciation + Amortization

Put It All Together to Determine Free Cash Flow

As you can see, the equation for free cash flow is quite cumbersome.

Free Cash Flow = Net Income + (Depreciation + Amortization + Gains/Losses on Investments + Stock-Based Compensation + Impairment Charges) **–** ((Current Period AR – Prior Period AR) **+** (Current Period Inventory – Prior Period Inventory) – (Current Period AP – Prior Period AP)) **–** (Current Period PP&E – Prior Period PP&E + Depreciation + Amortization)

Typically, this single equation is simplified by calculating each of its components separately. So, the **commonly accepted equation for free cash flow** is:

Free Cash Flow = Cash from Operations – Capital Expenditures

Free Cash Flow Compared to Other Valuation Metrics

- **Free Cash Flow to Equity (FCFE) -** This metric is basically free cash flow adjusted for debt. FCFE measures the equity value of a company, in other words the amount of money available to equity shareholders after paying all expenses, debts and reinvestment costs.
- **Free Cash Flow to Firm (FCFF)** - FCFF describes a company's enterprise value, or the amount of cash available through both debt and equity.
- **EBITDA (Earnings before Interest, Taxes, Depreciation and Amortization)** - One of the metrics more commonly used to discuss and compare business valuations, EBITDA reflects a company's value apart from its finance and accounting decisions. Basically, EBITDA is calculated by adding interest, taxes, depreciation and amortization back into net income. EBITDA uses accrual accounting, which means the metric gives lots of weight to the decisions and expectations of a company's management and board.

Although these can all be useful metrics in valuing a company, free cash flow provides the most accurate and objective estimate of a company's present value, the cash leftover.

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Use Your Free Cash Flow to Grow Your Business

Free cash flow is a number usually discussed from the perspective of investors. Free cash flow, however, is also an important number for business owners – even those who are not looking to raise capital by selling equity. Positive or negative free cash flow can sometimes indicate a company's health.

By tracking your company's free cash flow, you can also measure your business's growth and success. Owners of companies with consistently positive free cash flow enjoy a multitude of options regarding how to use the leftover money.

Free cash flow can be used to expand operations, bring on additional employees or invest in additional assets, and it can be put toward acquisitions or paid out in dividends

to shareholders. Having too much free cash flow, however, can indicate that a business is not properly leveraging its assets, as excess funds could be put toward expansion.

On the other hand, the owner of a business with negative free cash flow should evaluate why FCF is negative. If the business has negative free cash flow because "extra" money is consistently reinvested for growth, then the negative number is a reflection of that growth strategy. When cash flow shortages are to blame, however, negative FCF could be a cause for concern.

A business owner, plagued with negative free cash flow as a result of a cash flow shortage, might need to restructure operations or raise capital by taking on additional debt, selling equity or investing personal funds.

How To Increase Free Cash Flow In Your Business

1. Restructuring debt to lower interest rates and optimize repayment schedules.
2. Reducing, limiting or delaying capital expenditures.
3. Hiring a CFO, or fractional CFO to improve financial strategy and business operations with management accounting.

In addition to monitoring their income statements, [balance sheets] and cash flow statements, business owners can use free cash flow to take the temperature of their businesses, measure growth and make data-driven decisions to drive profits.

Enhance Your Free Cash Flow With GrowthForce Outsourced Accounting Services

Outsourced accounting can significantly enhance your free cash flow by streamlining financial processes and optimizing resource allocation.

By entrusting accounting tasks to specialized professionals, you can minimize operational inefficiencies, reduce overhead costs, and eliminate the need for extensive in-house accounting infrastructure. This allows your business to focus its resources on core revenue-generating activities.

Additionally, outsourced accounting experts can provide accurate financial insights and analyses, enabling informed decision-making that aligns with your cash flow objectives. With a well-managed financial framework, you can better predict and manage cash inflows and outflows, ensuring optimal liquidity and capital availability for strategic investments and operational expansion.