Cash Flow

Following the Money, Not Just the Profit — Lesson Explainer

The Concept

The cash flow statement shows real money moving in and out, split into three sections: operating (core business), investing (long-term assets), and financing (lenders and shareholders).

Free cash flow (FCF) = operating cash flow minus capital expenditures - what's actually left to pay dividends, buy back stock, or pay down debt. Compare net income to operating cash flow: a persistent gap often means profit is being recognized before cash is collected.

The Three Sections of a Cash Flow Statement

Operating

+$68M

Cash from the core business - compare against net income.

Investing

-$25M

Spent on equipment/property - negative usually means reinvesting.

Financing

-$15M

Paid to lenders/shareholders - debt repayment, dividends, buybacks.

FCF here: $68M operating cash flow minus $22M of capex = $46M free cash flow - real money generated after keeping physical assets maintained.

Illustrative Example: When Profit and Cash Diverge

Line Item	Year 1	Year 2
Net Income (from income statement)	**$40.0M**	**$52.0M**
+ Depreciation & Amortization	$12.0M	$13.0M
- Increase in Receivables	$4.0M	$38.0M
- Increase in Inventory	$3.0M	$5.0M
Operating Cash Flow	**$45.0M**	**$22.0M**

Year 2 net income grew 30%, but operating cash flow fell - receivables jumped from $4.0M to $38.0M. The company booked more sales but collected proportionally less cash.

5 Things to Know About Cash Flow

1. Free cash flow is often more trustworthy than net income - harder to manipulate.
2. Operating cash flow persistently below net income is a warning sign.
3. Negative investing cash flow is usually healthy - it means investing in growth.
4. Negative financing cash flow can be a good sign - paying down debt or returning cash.
5. FCF funds everything discretionary - dividends, buybacks, and debt paydown.

4 Things to Check When Reading a Cash Flow Statement

• Compare net income to operating cash flow - a widening gap is worth digging into.

• Read investing activities in context - maintenance capex vs growth/acquisitions.

• Check what financing activities fund - debt paydown funded by real FCF is healthier.

• Track FCF trend over several years, not just one.

Worth knowing:
cash flow completes the picture started by the income statement and balance sheet. A company can report solid profit and a clean balance sheet while cash flow quietly tells a different story.

Quiz — Answer the questions, then check the key on the next page

1. What is free cash flow?

A. Total revenue for the year
B. Net income minus taxes
C. Operating cash flow minus capital expenditures
D. The cash a company has in the bank right now

2. What does it usually mean when operating cash flow falls well below net income?

A. The company is definitely committing fraud
B. It's always a sign the stock will rise
C. Nothing - it happens completely at random
D. Rising receivables/inventory may be quietly tying up cash

3. Why is negative investing cash flow usually not alarming?

A. It always means the company is going bankrupt
B. It typically means the company is spending on its own growth
C. Investing cash flow is never negative in practice
D. It means the company has stopped operating

4. Why can negative financing cash flow be a good sign?

A. It can reflect paying down debt or returning cash via dividends/buybacks
B. Negative numbers are always bad in every context
C. It means the company borrowed a lot of new debt
D. Financing cash flow is unrelated to debt or dividends

5. Why did operating cash flow fall in Year 2 despite net income growing 30%?

A. Because revenue fell that year
B. Because depreciation went to zero
C. Because receivables jumped sharply, tying up uncollected cash
D. Because the company paid off all its debt

Answer Key

1. What is free cash flow?

Correct answer: C. Operating cash flow minus capital expenditures

Free cash flow is real money left over after maintaining/growing the business's physical assets.

2. What does it usually mean when operating cash flow falls well below net income?

Correct answer: D. Rising receivables/inventory may be quietly tying up cash

A persistent, widening gap often means profit is being recognized before cash is collected.

3. Why is negative investing cash flow usually not alarming?

Correct answer: B. It typically means the company is spending on its own growth

Negative investing activities usually reflect reinvestment in physical assets - normal and healthy.

4. Why can negative financing cash flow be a good sign?

Correct answer: A. It can reflect paying down debt or returning cash via dividends/buybacks

Financing cash flow going negative often means paying down debt or returning cash to shareholders.

5. Why did operating cash flow fall in Year 2 despite net income growing 30%?

Correct answer: C. Because receivables jumped sharply, tying up uncollected cash

Receivables jumped from $4.0M to $38.0M - more sales booked but proportionally less cash collected.