

# Cash Flow from Operations: Why Real-Life Companies Are More Complicated Than Investopedia



The trickiest part of the Cash Flow Statement adjustments and projections...



# Cash Flow from Ops.: Welcome to the Real World

I wanted to cover this topic because there's a **huge divergence** between **real life** and **accounting textbooks**, online articles, etc., here.

The **Cash Flow from Operations** section of the CFS requires the most adjustments and subtlety in the projections.

# Cash Flow from Ops.: Welcome to the Real World

If you want this tutorial in writing, along with screenshots, PDFs, and the Excel model, go to this URL (**pinned in the comments**):

<https://breakingintowallstreet.com/kb/accounting/cash-flow-from-operations/>

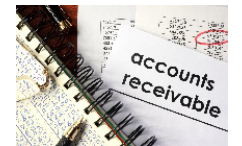
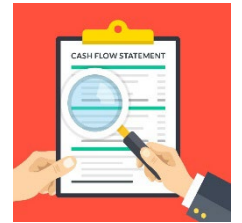
# The Short Answer...

- **CFO:** Net Income, adjusts for non-cash income and expenses, and reflects the Change in Working Capital; **recurring cash flow before CapEx and other investing/financing activities**
- **Direct Method:** CFS built this way shows cash inflows and outflows in this section rather than all these adjustments
- **CFO** = Net Income + D&A and Other Non-Cash Adjustments +/- Deferred Taxes +/- Change in WC
- **CFO** = EBITDA – Cash Net Interest – Cash Taxes + Non-D&A Non-Cash Adjustments +/- Change in WC



# The Short Answer...

- **Complications:** Non-cash adjustments are tricky, and many non-U.S. companies have confusing Cash Flow Statements
- **CFO:** *Not* a proxy for EBITDA! Quite different if you use real #s
- **Correspondence:** CFO *mostly* represents the Current Assets and Liabilities on the Balance Sheet
- **Uses:** Used in almost all valuations and financial models, but more as an “intermediate step,” not a valuation metric or multiple (not great for comparison purposes)



# The Short Answer...

- **CHECKLIST:** If your CFO section starts with a metric like Net Income or EBITDA:
- **Cash Taxes:** Must be deducted in CFO, directly or indirectly
- **Cash Net Interest Expense:** Must be deducted in CFO
- **Change in Working Capital:** Must be here (could be + or –)
- **No CapEx, Investments, Debt, or Equity:** Wrong section!
- **Non-Cash Adjustments:** Must make sense for the starting metric!



# Cash Flow from Operations: Outline

- **Part 1:** Real-Life Cash Flow from Operations Adjustments **5:50**
- **Part 2:** Why CFO is Not an Ideal Valuation Metric **13:46**
- **Part 3:** Industry-Specific CFO and Variations in Oil & Gas **15:15**

# Part 1: Real-Life CFO Adjustments

- **PROCESS:** There's no universal process that works for all companies, but you can use the checklist as a starting point
- **Target:** Minimal adjustments; would zero out SBC and Gains/Losses in the forecasts and consolidate a bit
- **Watches of Switzerland:** Must put Net Interest Expense in CFO; FCF calculation is incorrect and must deduct all CapEx
- **Telstra:** Find an Indirect version first; delete the Net Interest reversals; zero out SBC/Gains/Impairments; investigate Cash Taxes



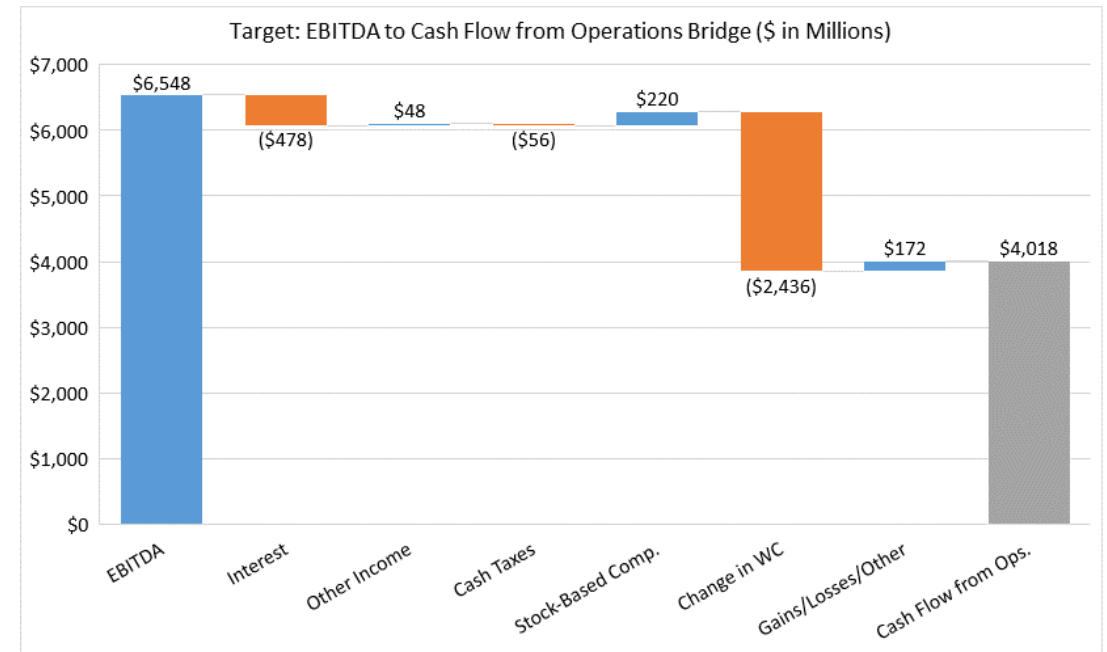
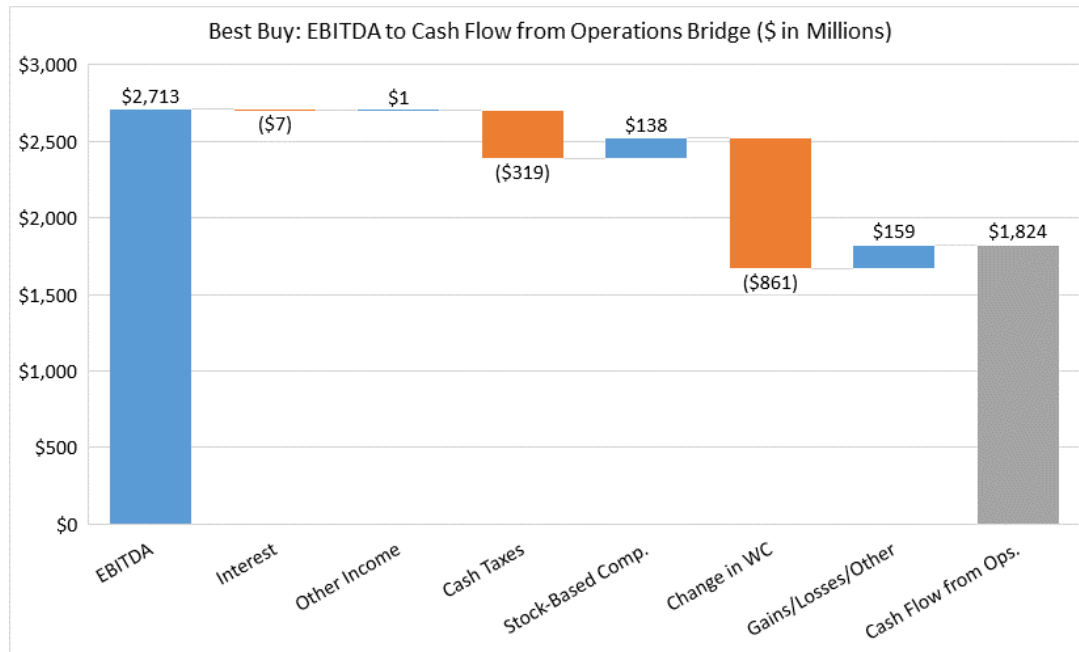
# Part 2: Why CFO is Not an Ideal Valuation Metric

- **Valuation Metric Purpose #1:** Allows for an easier, “apples to apples” comparison of companies
- **Valuation Metric Purpose #2:** Approximate the company’s cash flows, either to all investors or just equity investors
- **Cash Flow from Operations:** The worst of both worlds! Does neither one well
- **Why:** Huge range of non-standard adjustments, *but* it also excludes CapEx, one of the most significant cash-flow lines



# Part 2: Why CFO is Not an Ideal Valuation Metric

- **And:** CFO is not particularly “close” to EBITDA, so it’s best to use metrics like EBITDA or even EBITDA – CapEx for comparisons



# Part 3: Industry-Specific CFO and Variations

- **Some Industries:** Will use multiples such as Equity Value / Cash Flow from Operations, known as P / CFO
- **Oil & Gas:** Quite common; also see variations like Adjusted Funds Flow from Operations (AFFO) in Canada and non-U.S. regions
- **Logic:** Capture **capital structure** and **cash taxes**, but normalize/ignore differences in CapEx
- **Our View:** This is a bit silly because CFO is still an “in between” metric → Better to use Net Income or Free Cash Flow



# Recap and Summary

- **Part 1:** Real-Life Cash Flow from Operations Adjustments
- **Part 2:** Why CFO is Not an Ideal Valuation Metric
- **Part 3:** Industry-Specific CFO and Variations in Oil & Gas

