Analysis of Cash Flow Statements

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Table of Contents

[*Introduction* 3](#_Toc9454749)

[*What information is presented in the income statement?* 3](#_Toc9454750)

[*What information is presented in the statement of Cash flows?* 3](#_Toc9454751)

[*Relative Information* 4](#_Toc9454752)

[*Analysis* 5](#_Toc9454753)

[*Answer 1. A.* 5](#_Toc9454754)

[*Answer 1. B.* 5](#_Toc9454755)

[*Answer 1. C.* 7](#_Toc9454756)

[*Answer 1. D.* 7](#_Toc9454757)

[*Answer 1. E.* 8](#_Toc9454758)

[*Answer 1. F.* 8](#_Toc9454759)

[*Answer 1 G.* 9](#_Toc9454760)

[*Answer 1. H.* 9](#_Toc9454761)

[*Answer 1.I.* 10](#_Toc9454762)

[*Answer 1. J.* 10](#_Toc9454763)

[*Answer 1. K.* 10](#_Toc9454764)

[*Answer 1. L.* 10](#_Toc9454765)

[*Answer 2* 11](#_Toc9454766)

[*Answer 3* 11](#_Toc9454767)

[References 12](#_Toc9454768)

# *Introduction*

There is a difference between the net income reported by the business in the income statement and the amount of cash that is shown in the statement of cash flows. The amount on the income statement affects the amount of cash flow in a manner that we cannot ignore the relationship between the two. More specifically this relationship is evident between the income statement and the section of cash flow statement that summarizes the operations of the company. The basic aspect of this relationship shows the extent to which net income can result in the cash flow for the company.

## *What information is presented in the income statement?*

The major information contained in the income statement comprises of the revenues and expenses incurred by the company in a period of time. The major part of revenues come from the sale of company’s products. The expenses, on the other hand, are the outflows of cash that are necessary to generate the revenues. The important consideration while making the income statement is that the revenues should be matched against the expenses incurred to generate these revenues.

## *What information is presented in the statement of Cash flows?*

This statement shows the ways in which the company collects and spends the cash available. There are three activities that are presented in the statement namely operating, investing and financing activities. The section that shows the major business of the company is the operations section. This shows the amount of money that comes in and goes out in relation to the sales of the product. The investing activities show the movement of cash in relation to the long-term investments and resources. The loans and other modes of investment are shown in the investment section of the cash flow statement.

## *Relative Information*

The operations section in the statement of cash flows contains the information that is relevant to the income statement. The income statement and cash flows from operations sections contain the amount of sales that have been made by the business. The investing and financing activities also include some of the information from an income statement. The example can be taken regarding the expenses and incomes related to the current period. In fact, all the payments that are revenue in nature, will be shown in the income statement as they will pertain to the current financial term for the business. The net income is an opinion in the sense that it is obtained after putting in place certain assumptions regarding expenses and revenues. The cash flow is a realistic figure that is not affected by any assumptions. If anyone wants to study the position of the company, he should use the cash flow as it will provide him with a single figure. The criteria applied by the person will decide whether the person will be using net income or some other figure to judge the position. Thus, the use of cash flows is much better as compared to the use of net income.

The investor is interested in both the net profit that is shown in the income statement and the figures which are shown in the statement of cash flow. The net profit shows the ability of the company to pay the dividends to the shareholders. A part of this net profit is kept by the company in the form of retained earnings. These retained earnings are used by the company in the extension projects or in buying the fixed assets. The statement of cash flows shows the amount of net cash in the hand of the organization. Firstly, this shows the ability of the company to successfully run the operations and generate sufficient cash from it. This same cash is used to finance the investing and financing activities undertaken by the companies. Some companies generate cash from investing or financing activities. The cash generated from the financing activities comes from the issuance of new shares which is not a permanent source of cash inflow. The investors will be interested in the cash flow statement because this will show the ability of the company to generate cash from the operations and other activities.

# *Analysis*

## *Answer 1. A.*

|  |  |  |  |
| --- | --- | --- | --- |
|  | Funtastics | BHP | Santos |
| Major Source of Inflow | Financing Activities | Operations | Operations |
| Major Source of Outflow | Operations | Financing  | Investing |

The above table shows the major sources of cash inflows and cash outflows for all the companies under consideration. BHP Company has such operations which are generating a good amount of cash. This amount of cash is enough to cover the outflows for the company both in the financing and investing activities. However, one drawback of the BHP Company is that it is putting the cash flow from operations into the financing activities. This may mean that the company is servicing the debts and is paying them off with the help of cash flow from operations. The funtastics company is the worst one because it has not been able to generate enough amount of cash from its operations. This company is in such a position that the operations have become the major source of cash outflows. The best company is Santos which has generated sufficient cash from the operating activities and this excess cash is used to buy fixed assets.

## *Answer 1. B.*

The trend for the cash flows from continuing operations shows that the said figure has been increasing over the period of three years. This is applicable to the two companies namely BHP and Santos. The company named funtastics has shown negative cash flows from operations over the period under consideration. This situation can have serious implications for the company because this shows that the major operations of the company have not been able to produce considerable amounts of cash for it. The same company has been able to generate positive cash flows from the financing activities. In the financing activities, the major portion of financing has come from the new issue of shares by the company. This trend is useful for the external users because the first and foremost thing that the external users will observe is the cash flow from operations for any company. The cash flow from operations for Funtastic limited has been negative for the last three years. The situation has worsened in the year 2018 as compared to the years 2016 and 2017. If we observe the numbers closely, the cash utilized by the operations has increased over the period under consideration. This may be due to the fact that the company has extended the operations and had to put in cash. This may benefit the company in the long run. The BHP Company limited has shown a positive trend regarding the cash flow from operations. The increase in the cash flows was more from the year 2016 to 2017 as compared to 2017 to 2018. If we look closely at the figures, the major increase has been shown in the profit before taxation for the company. This may mean that the company has either increased the sales in the said period or it has managed to control the expenses that are recorded in the income statement. The company named Santos limited has also managed to show a consistent increase in the cash flows from operating activities. The increase from the year 2016 to 2017 is greater than the increase from the year 2017 to 2018. The major increase in this regard can be seen in the cash received from the customers in terms of sales proceeds. This means that the company is focusing successfully on major operations. Actually, these companies are using different methods to make the statements of cash flow. Companies A and C are using the direct method as they both have started the statement with the receipts from customers. Company B has used the indirect method to make the statement as it has started the statement from the profitbefore taxation(Penman, 2013)**.** The statement of cash flow allows the management to evaluate the liquidity of the operations and also to analyze how well the company is managing the cash. The analysis of cash flow statement also includes an overview of the working capital for the company. The reason for this inclusion is that the operating activities result in the changes in current assets and current liabilities of the companies which are used to calculate the working capital.

## *Answer 1. C.*

The net income has been recorded in the cash flow statement as profit before taxation. The net income specifically shows the effects of immediate operations undertaken by the company. These include the income and expenditures related to the sales of the company. The sales amount includes both the cash as well as credit sales. The statement of cash flows considers the cash aspects of the transactions only. The income statement is not concerned with the changes that take place in the assets and liabilities whereas the statement of cash flows considers these changes. These adjustments have to be made because these are not related directly to the production of goods and services. If the company is running the operations appropriately, the net cash flow from operations will be more than the net income for the business. The problem for the person preparing the statement of cash flows is that he has to convert the profit from the accrual basis income statement to the cash basis used to make the statement of cash flow.

## *Answer 1. D.*

Yes, the company was able to pay the capital expenditures out of the cash flows generated from operations. This is evident from the fact that cash flow from operations is positive and are more than the sum of the negative cash flow generated by the company in investing and financing activities. The company has undertaken the operations in such a manner that it has generated enough cash to cover the negative cash flows from the other two activities. The external assessment made by some party will see that the company was able to pay dividends and also cover the negative cash flows from investing and financing activities with the help of positive cash flows from operating activities.

## *Answer 1. E.*

In the scenario given, company A has not been able to pay any dividends because the company has negative cash flows from operations (Puspitaningtyas, 2017). This has not allowed the company to pay the dividends. The positive aspect with respect to company A is that it has a big positive cash flow from the financing activities. This part mainly comprises of the shares issued by the company. In the case of company B, it has been able to generate positive cash flows from operations and it has also covered the capital expenditures and dividend payments out of these cash flows. The company will be able to cover the negative cash flows from financing and investing activities from its operations activity. In the case of company C, the company will be able to pay the dividends out of the cash generated from operations. However, the negative balance from investing activities cannot be covered by the cash flows from operations. The company also has a positive cash flow from the financing activities which makes things better for it.

## *Answer 1. F.*

In the case of company, A, it has not been able to generate positive cash flows from operations. The only positive for the company is the cash flow from financing activities. The company has used the cash accumulated from the new share issue to finance capital expenditures. This approach is not good because this is not a long-term source of cash inflow. Company B has generated enough cash flow from the operations to manage the capital expenditures and to pay out the dividends. This is the only company that is able to generate that much cash flow from operations that it can cover the negative cash flows from the investing and financing activities. In my opinion, this company should have issued new share capital to convert the negative cash flow from financing activities to positive cash flow. This will also help the company to incur more of the capital expenditures out of the cash flows generated from operations.

## *Answer 1 G.*

The major changes in the assets and liabilities of BHP company do not relate to the cash and cash equivalents. The reason for this judgment is that there is a considerable increase in the current assets section of the company. While converting from the accrual basis to the cash basis, the increase in current assets is shown as a negative in the statement of cash flows. As shown in the parallel statements of cash flows, we can see that the trade and other receivables have been shown as negative from the period 2017 to 2018. This shows that there has been an increase in various receivables. Similarly, the amounts of increase in the current liabilities are shown as a positive figure while converting from the accrual basis to cash basis. As seen in the statement of cash flows, there is a considerable increase in the trade and other payables over the period of 2017 to 2018. The changes in the current assets and current liabilities show that there have been changes in the accounts other than cash and cash equivalents.

## *Answer 1. H.*

For company A, there is no considerable aspect in the investing and financing activities part. The cash balance at the end of the year shows a similar pattern as the cash flows from operations. However, by issuing the shares for the general public, the company has been able to generate positive cash flows from the financing activities. If we talk about company B, we see a large number of items that have been presented in the cash flow statement. Most of these items have a positive impact on the overall financial condition of the company. This company has tried to convert the accrual basis of accounting to a cash basis. Company C has an unusual item in the financing activities named drawdown of borrowings.

## *Answer 1.I.*

For company A, the capital expenditures have decreased over time under consideration. This can be seen in the investing activities in the name of payments for plant and equipment. For company B, the amount under the same head has increased from the year 2017 to 2018, the same amount had decreased over the period 2016 to 2017. For company C, there has been a minor increase in the capital expenditures as shown in the head acquisition of oil and gas assets. This head showed a slight decrease from the year 2016 to 2017 and a slight increase from the year 2017 to 2018.

## *Answer 1. J.*

Company A did not pay any dividends. Company B increased the number of dividends paid from the year 2017 to 2018. The same amount had decreased from the year 2016 to 2017. The same pattern is visible in the net cash flow from continuing operations. Company C has paid a minimal amount of dividend over the period under consideration.

## *Answer 1. K.*

For company B, the repayments are more and the proceeds from borrowings are less. For the company, only the information from proceeds has been given. For company C, the proceeds for borrowing are high and the repayments are low.

## *Answer 1. L.*

The increase in the current assets shows a negative amount on the statement of cash flow when the accrual basis is converted to a cash basis. If the current liabilities are increased, this will mean that the expenses on credit have been increased over the period of financial statements. This will also show that the actual cash expenses were lower than those shown on the statement of profit and loss made on the accrual basis.

# *Answer 2*

The major source of strength for any company should be the operations undertaken by it. The performance of Companies A and C has not been good. The major concern in this regard is company A, which has negative cash flows from operations in all the three years. Company C is a little better as it has been able to generate positive cash flow from operation. In order to cover the discrepancy in the operations section, company A has issued shares and collected cash. This practice will not help the company in the long run. If we talk about company B, this company is in a much stronger position as it has been able to generate enough cash from the operations to cover the deficits in the investing and financing activities. The company has also paid dividends with the help of the cash that is generated from the operations. The only consideration that has to be made is that the company is converting the accrual aspects to cash basis, this may make some difference as compared to other companies which are using the cash basis of measurement. Company C has been able to generate positive cash flows from operations. This has allowed the company to pay some dividends to the shareholders. The company has not been able to produce an overall positive cash flow for the year 2018, the opening cash flow has helped it to bring the cash flow to a positive amount.

# *Answer 3*

As a lender, the company chosen will be company B, the reason for this choice is that the company has been able to generate positive cash flows from the operations. If somebody lends some amount to the company, the company will be in a position to pay the loans back. The company has shown good cash management over the period of time under consideration which will ensure the lender that the loan will be repaid. The negative cash flows from investing and financing activities may distract the lender but these negative numbers are collectively less than the cash flow generated by operations of the company. This means that the company will have enough free cash flows to pay off the loans. If this same trend continues, the company will gradually increase the cash flows from operations and this will increase the confidence of the lenders.

# References

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