A Guide to Understanding Cash Flow Statements

INTRODUCTION

While the general premise of this guide may be applied to all companies, this guide has been developed to assist in analysing a cash flow statement that has been prepared for the annual report of a listed company.

Therefore, it is assumed that the cash flow statement has been audited and prepared in accordance with AASB 1026 Statement of Cash Flows (or AASB 107 Cash Flow Statements for reporting periods commencing on or after 1 January 2005). If the cash flow statement has been prepared for a parent and its subsidiaries, the focus should be on the consolidated cash flows rather than the parent entity cash flows. Consolidated cash flows enable an analysis of the cash generating abilities of the group as a whole.

CONTENTS OF A CASH FLOW STATEMENT

A cash flow statement will be presented so that it identifies the cash flows arising from the operational, financing and investing activities of the entity.

Operating activity cash flows are derived through revenue producing activities and will ordinarily comprise cash flows:

- from customers for the sale of goods and services
- from royalties and commissions
- from and to the tax office
- to suppliers of goods and services
- to employees

Cash flows from investing activities are generally related to activities focused on producing future revenues for the business and will ordinarily comprise cash flows:

- from the sales or purchase of property, plant and equipment
- from the sale or purchase of investments

Cash flows from financing activities can assist in predicting future cash flow requirements of the providers of capital and will ordinarily comprise cash flows:

- from issuing shares and debentures
- to fund share buy back shares
- from the repayment of loans made
- to financiers for loans received

BENEFITS OF A CASH FLOW STATEMENT

A cash flow statement provides useful information for assessing the ability of the business to generate cash flows from its various activities. In essence this means that such a statement is a summary of all transactions that have been reflected in the bank statements of the business. From this assessment, the user can, for example, conduct critical ratio analysis in order to evaluate the liquidity and solvency of the business. Without the statement of cash flows, there is a significant limitation on the scope of analyses that can be performed using financial reports.

Cash flow analysis is vital to determining whether a business can continue as a going concern and whether or not additional funding is required to support the working capital and long-term borrowings of the business.

WHAT TO LOOK FOR WHEN ASSESSING CASH FLOWS

Cash flow statements are prepared using historical cash flow information and accordingly may only provide an indicator of the amount, timing, and certainty of future cash flows. Furthermore an assessment of cash flows will assist in determining the nature of the relationships that exist between the profitability of the business and its cash flows (i.e. that profit is actually converted into cash).

In understanding the cash flows of the business, consideration should be given to the following:

- reasons why profit and cash flows differ (eg: non-cash items)
- sources of funds to finance business activity and expenditure
- whether cash generated from profits is being applied to fund repayment of borrowings, payment of dividends or fund working capital of the business
- whether property, plant and equipment are being updated

The cash flow statement and related reconciliation of net profit from ordinary activities after income tax to net cash inflow from operating activities provides users with a much clearer understanding of how much cash has been collected of the declared profit (or loss) for the reporting period. Moreover the cash flow statement can provide users with a good understanding of the movements of assets and liabilities in the statement of financial position against the comparative period. Ideally all three statements in the financial report should be considered together for a full assessment of the financial position and performance of the entity for the period.

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