

Relative advantages and limitations of financial statements

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To compare the advantages and limitations of different financial statements begins with first understanding what financial statements are and what different purposes they can be used for, as well as the differentiation between cash and accrual accounting. The cash and accrual methods of accounting are the two principle ways of keeping track of businesses takings and expenses and in the majority of cases it is possible to decide which method is best for a business on an individual basis, although in all cases cash based accounting can only apply to small businesses earning less than £1. 35 million, so large businesses will always have to rely on the accrual based method to prepare their financial statements.

Financial statements are written reports that describe the financial status of a company; it is one of the main functions of financial accounting. It consists of a profit and loss account and a balance sheet. Within the financial statement there are a few limitations that apply to both accrual and cash based accounting, the first thing is that the financial statement is 'largely historical', meaning that it can tell you what an entity has done positive or negative in the previous overview but it cannot necessarily 'reflect future events or transactions'. The financial statement also mainly focuses on the financial effects of the company and not, essentially, the non-financial effects or information in general. But as an advantage the financial statement can be used as the main source of a company's activities for those who do not have full ability to access a company's economic activity.

Cash-based prepared financial statements are those that are recognised when a fee has been received or paid. A cash basis would mean that a payment is shown even if a service has not yet been provided or good has

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not yet been shipped. An advantage of this is that it can provide an accurate image of how much profitability at the current time within a business because it shows revenue being counted when funds are exchanged and when cheques, for example, are handed over.

Accrual-based accounting is a concept where non-cash effects of a company's transactions are reflected in the 'period in time at which the costs have been incurred', rather than when cash is paid. According to FRS18, an entity should prepare its financial statements 'on the accrual basis of accounting'. It corresponds with the accrual idea that all revenue and costs are accrued, so that revenue is recognised when products are dispatched or the service has been provided. One advantage because of this is that you can use the 'matching method' where income, whether it has been received or not can be matched to a cost whether that cost has yet to be paid, or not. This can show the true match of revenue, with the cost used to make the revenue, showing a more reasonable picture of a company's transactions.

The limitations for financial statements prepared on a cash basis are that even though it may show what cash is in the bank at the present, in the long run it can distort the true picture of how much money a company actually has. For example, a company may be appearing to be profitable in one month even if sales in the books have been slow because several creditors may have paid them. This means that could keep having several months with slow sales but the extent of the damage may not be apparent to the

business until too late when it could be too late to save a business from bankruptcy.

Accrual based financial statement has the disadvantage that although it shows the ins and outs of business income and debts more accurately, it can distort what cash is actually available, which could result in cash flow problems. For example, a takings ledger may show multiple sales, when in fact because it is owed by creditors it may be seen that there is not much money within the business.

Cash based accounting can work for small businesses for tax reasons, if you use cash accounting for VAT then you don't need to pay it until the customer has paid you. If the customer never pays then you will never have to pay the VAT. This can only apply to small businesses because once a business' income exceeds £1.6 million pounds then it must use the normal VAT system. A benefit of using cash based accounting for VAT is that it could help your cash flow, especially if an entity's customers are slow payers. But the entity can also be disadvantaged because; if you buy most of your stock or services on credit you can't reclaim the VAT until you have paid your suppliers.

In conclusion, financial accounting in general has many advantages and limitations, it can present shareholders and members of the business how it has been doing and is sometimes the most available picture for people with limited access to a company's information. But on the other hand it also mainly based on the past and cannot necessarily reflect what is too happen in the future. Cash based financial statements as we have seen can be

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beneficial for small businesses to use because of tax reasons; it means that VAT only has to be paid when a customer has paid the business.

But cash accounting also has its limitations; in the long run it can distort the real impact that transactions are having on a business. To prepare financial statements with the accrual method seems to be the most desirable method for a business, as you can use the matching method where income can be matched to a cost. Accrual also means that revenue can be recognised when a service or good has been provided making the transactions of a company clearer and more precise.