

# [Understanding financial statements essay sample](https://assignbuster.com/understanding-financial-statements-essay-sample/)

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The cash flow statement provides information beyond what is shown in the income statement. Since the income statement is made on the accrual basis of accounting rather than cash basis, it will always differ from the cash flow statement. The cash flow statement provides the following information:   
- Information about the company’s cash cash receipts and cash payments during an accounting period   
- Information about the company’s operating, investing and financing cash flow activities   
- A transparent view of company’s performance as it provides an understanding of the impact’s of accrual accounting events on cash flows.   
The cash flow statement reconciles the beginning and ending balance of cash over an accounting period. The change in cash is a result of the firm’s operating, investing and financing activities as follows:

## Operating Cash Flow

+Investing Cash Flow   
+Financing Cash Flow   
= Change in cash balance   
+ Beginning Cash Balance   
= Ending Cash Balance

## Explaining the difference of transactions on Income Statement and Cash Flow Statement:

All the items on income statement are recorded using accrual basis of accounting and thus it shows a company’s profitability on accrual accounting basis. In other words, it illustrates a company’s revenue, expenses and net income through accrual accounting which requires that an entity must record its transaction i. e whether it is related to income or expenses, when they are incurred. Thus, the entries are posted not when cash is received or is paid, but rather when they are earned or expended. Although the accrual basis of accounting, has associated benefits with it as it shows a accurate picture of the company’s profitability but at the same time can be used as a tool for manipulating the accounting picture.   
Thus, these shortcomings are addressed by cash flow statement. The cash flow statement identifies all of the cash inflows and outflows of a business and whole of the statement is made on cash basis rather than accrual basis. Thus, an entity cannot easily manipulate its cash position and it is through this financial statement that actual position of an entity is disclosed. Thus, for the purpose of obtaining a strong and accurate financial analysis, both income statement and cash flow statement should be used in conjuction because if a company has reported a high net income then it must be supported with high cash flows and vice versa and if this is not the case, then it is needed to investigate why such discrepancy exists.

## Explaining the difference using given financial statements:

The Income Statement of the company reports a net income of $147150 while operating expenses have been reported to be $114950. Considering the high net income of the company, as we have discussed earlier, if the company is showing true image of its accounting transactions in the income statement, it must have considerable high operating cash flows.   
In terms of cash flow statement we prepared the cash flow using indirect method of preparing cash flow statement. Under this method, net income from income statement is converted to operating cash flow by making adjustments for transactions that affect net income but are not cash transactions. Thus, the process starts by eliminating non cash expenses i. e depreciation and amortization, non-operating items and any change in current assets or current liabilities in balance sheet accounts resulting from accrual accounting items.   
Similarly, as for the cash flow statement so prepared, we started the process using net income of $147150 and then added back depreciation expenses of $24350. Further, considering the increase in inventory, we subtracted the increased amount from operating cash flow and finally we had actual operating cash flow of the company amounting to $129000. Thus, with the proportion of 1. 14: 1 between net income and operating cash flow we can conclude that company is showing a true image of its accounts to the investors and analyst.   
Further, for Investing and Financing Cash Flow, we can notice that the company ended up with negative investing cash flow of -$400000 while for the financing cash flow, major portion of the cash position shown in the balance sheet is from the borrowings generated through equity and debt financing. The company during the year issued common stock of $150000 while the amount borrowed was $360000. Overall, the total change in cash during the year from CFO+ CFI + CFF was $224000.   
Thus, it is clear that cash flow statement offers a better and transparent picture of the company by bifercating each transaction on the basis of its nature and also provides a real cash flow position to the investors by eliminating non-operating and non-cash expenses from net income.

## Works Cited:

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