

Example of statement of cash flows essay

Business, Company



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A statement of cash flows, also known as the cash flow statement gives an explanation as to how a company manages its funds. It was formerly known as fund flow statement. It is part of the financial statements and complements such statements as the income statement and balance sheet. It accounts for cash and cash equivalents that enter and leave an organization. The main objective of a cash flow statement is to offer information regarding a company's cash transactions during a given financial year. It also provides information concerning an entity's operating activities, investing activities as well as financing activities.

It is legally required that every registered business entity provides a cash flows statement so as to facilitate proper analysis of its financial statements by users of accounting information. Requirements of the law ought to be followed strictly and, therefore as part of a business' strategic plans, reporting standards should be fulfilled for it to be successful in the current environment. In the determination of an organization's capital structure, and also explain the reason for the existence of overdraft in spite of business profits, a statement of cash flows is needed to clarify the components that make up the organization's business structure.

When valuing a business entity for appraisal by investors, the statement of cash flows would come in handy. The method applied in business valuation mainly depends on the investor's motive, in addition to some other variables. A company's profile can be forecasted by simply examining a business' cash flows statement. Business executives can examine the movement of cash and come up with intelligent forecasts about the business' future .

Through the components of a statement of cash flow that include operating,

investment and financing activities, the statement can provide concise information about cash movement in the entity. Lastly, the statement also helps to explain the behavior of a number of variables found in a financial statement. How a business raises cash, how it invests it and how the cash received is distributed can be clearly seen courtesy of this statement.

A statement of cash flows however cannot on itself give a full analysis of a firm's financial position. For it to be interpreted, it requires the support of the other financial statements and such analytical tools as ratio analysis.

Otherwise the information on it cannot be easily interpreted thus making it inadequate in financial reporting. Another criticism of a cash flow statement is that the information it presents comes from past business activities and therefore it does not take into account future growth, only concentrates in the firm's past. One may therefore not predict accurately the firm's future ability. In addition to these, the statement increases accounting workloads. Rather than use the traditional accrual accounting, a cash flow statement is based on cash and this demands that separate accounts are kept to record cash movement.

Historical information from the cash flow is important in assessing the timing, amount and certainty about future cash flows. It serves to as an indicator of the business' future. Accuracies of previous assessments concerning future cash flows can also be checked based on this historical information. It can also be helpful when analyzing the relationship between the net cash flow and the enterprise's profitability and effects of changing prices. Users of accounting information can be able to create models for the comparison of the present value of future cash flows of various businesses

by use of these statements. Since the use of the statement of account ensures the same accounting treatment for similar events and transactions, it enables comparison of different firms' operating performance.

Statement of cash flow is governed by IAS 7 which was originally drafted in 1976; however, it has undergone several changes over the years. It was last revised in April 2009 with the changes being effective from January 2010. However, there are still certain proposed changes to IAS 7 that have not yet been effected. The Financial Accounting Standards Board together with the International Accounting Standards Board deliberated on certain areas to be changed as concerns financial statements. They intend to introduce a system whereby managers separate an enterprise' actual business activities from the financing activities so that the balance sheet, the statement of cash flow and the income statement each gets divided into two major sections. The financing section would entail activities that finance a firm's business, whereas the business section will further be subdivided into investing and operating sections. It would involve the things a firm does to produce goods. The investing section will involve those activities that generate cash inflows but are not core while the operating section will entail primary revenue and activities that generate expenses .

The first major proposed change is a complete reorganization of the statement of cash flow of financial institutions in order to make it more useful, because the current presentation normally provides totals that are meaningless in evaluating the activities of financial institutions. Core on-balance sheet activities for financial institutions should be included in the operating section. The core operations of financial institutions are normally

divided into two; on-balance sheet activities and/or off-balance sheet activities. Normally, off-balance sheet activities primarily consist of fee-based activities for services they render that do not result in any asset or a liability. This creates no problem as they appear in the operating section of the statement of cash flow. The major problem is presented by on-balance sheet activities such as; accepting deposits, which appears on the statement of financial position as a liability, lending money, which appears on the statement of financial position presented as an asset, trading in securities, which appears on the statement of financial position presented as an asset. These are part of financial institutions core business and are logically expected that they will appear in the operating section; however, IAS 7 requires that they should be included in the financing section. This may mislead to potential users of financial statements.

The second proposed change is that interest and dividends paid should be classified in the same section. Financial statements should enable users make cross-sectional analysis, which is practically impossible for companies with different financing choices under the current IAS 7. This is because IAS 7 classifies interest under operating activities and dividend paid under financing activities. Earnings per share are, therefore, the only analytical measure that can be used to compare the performance of different companies. Another proposed change is that dividend received should be classified as investing activity as opposed to operating activity as it is currently classified. Classifying dividend received as an operating activity causes distortion of operating cash flows. If a company has substantial investments in affiliated companies, it can manipulate its own operating cash

flows by increasing the amount of dividends it receives from corporations it has invested in. This tool has been used by several companies to inflate their operating cash flows. It has also been proposed that cash flows from trading securities should be classified as investing activity, as opposed to being classified as operating activity as they are currently classified. This is because it is easier for companies to manipulate their operating cash flows by shifting cash flows between financial years by switching securities between “cash equivalents” and “trading securities”.

Lastly, it is proposed that capital leases should be accounted for under financing activities without splitting the principal and interest payment. Under the current IAS 7, the payment for the principal for a capital lease is normally treated as a financing activity, while the interest payment on the lease is treated as an operating activity. The principal payment and the interest payment on a capital lease is a single transaction and should be treated as such. By treating it as two separate transactions, it loses its wholeness and is less informative. Lastly, it is proposed that major non-cash financing instruments should be included in the statement of cash flow. This is in order to fully reveal financing engagements of the company.

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