Case study on statement of cash flows

Business, Company

A statement of cash flows, which also referred to as the cash flow statement gives an account of how a business manages its funds. It is part of the financial statements and complements other financial statements as balance sheet and the income statement. It accounts for cash and cash equivalents that enter and leave an organization. The chief objective of a cash flow statement is to offer information as regards an organization’s cash transactions in the financial year under consideration. It also provides information about an organization’s operating activities, financing activities and investing activities. This paper seeks to distinguish between indirect method and direct method of preparing statement of cash flows. It also seeks to distinguish operating activities and financing activities in statement of cash flows. Lastly, it seeks to compare statement of cash flow and income statement.

The direct method of preparing statement of cash flows uses actual receipts of cash from operating revenues and actual payments in cash for operating activities. The difference between the actual cash receipts from trade customers and the actual payments made in cash to employees and suppliers of goods gives the net cash from operating activities. On the other hand, the indirect method of preparing statement of cash flows uses the net income after tax which is then adjusted for items that did not affect the cash yet they affected the Statement of Income. The second difference is that a statement of cash flow prepared using the direct method only includes cash items. On the other hand, statement of cash flow prepared using indirect method contains non-cash items such as depreciation and impaired goodwill as adjusting entries. The differences in the indirect method and direct methods of preparing cash flows can only be observed in the operating activities section; the financing and investing activities sections are the same.

Cash flow from operating activities denotes cash inflows and cash outflows that are a direct result of the core business activities. It includes cash generated from customers from the sale of the company’s products or services and cash paid to employees as well as cash paid to suppliers of goods and services. On the other hand, cash flow from investing activities refers to cash inflows and cash outflows for the acquisition and sale of long term assets. It includes cash purchase or sale for assets such as buildings, equipment, and motor vehicles among others. It should also be appreciated that the process of arriving at net cash flow from operating activities by the direct and indirect methods are different. However, the process of arriving at net cash flow from investing activities is the same in both the direct method and indirect method of preparing the statement of cash flows.

Income statement shows an entity’s accounting profit or loss. It shows an entity revenue streams, expenses and consequently net income. On the other hand, statement of cash flows shows the movement of cash in and out of the organization. The main difference between income statement and statement of cash flow is that statement of income uses accrual basis of accounting whereas cash flow statements uses cash accounting. Accrual method of accounting recognizes and records revenues when they are earned irrespective of whether the goods or services have already been paid for. It also matches expenses to the related revenues in a given period irrespective of when the expenses were paid for. Accrual accounting provides a more accurate picture of a company's profitability. However, focusing on profitability and ignoring cash inflows and cash outflows provides management with a loophole to engage in creative accounting. In addition, a focus on accounting profits may make management concentrate less on cash management that is important in averting bankruptcy. The second major difference between income statement and statement of cash flows only considers cash items. Non-cash items are only included as adjusting entries. On the other hand, income statement includes both cash and non-cash items including depreciation and goodwill impairment. Measurement of non-cash items is often based on subjective estimates. In addition, non-cash items are often used by financial managers to manipulate accounting profits to achieve selfish interests. Lastly, income statement only considers items that contribute to the company's profitability; revenues and expenses. On the other hand, statement of cash flow considers any item that affects the cash flows of an entity. It includes operating activities, financing activities and operating activities.

Statement of cash flows is better than Income statement. This is because statement of cash flows overcomes the shortcomings of Income statements. Unlike income statement, statement of cash flows uses cash accounting. Cash accounting only considers actual cash inflows and cash outflows over a given time period. Therefore it overcomes the possibility of creative accounting since the net cash flows should be reconciled with the actual cash balance in the company. Secondly, statements of cash flows do not include non-cash items. Therefore, statement of cash flows overcomes subjectivity in income statements that results from estimating the value of non-cash items.

References

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