International Journal of Innovative Research in Engineering and Management (IJIREM)
ISSN: 2350-0557, Volume-9, Special Issue-10, October-2022
Innovative Projects 2022
Organized by Presidency University, Bangalore, India

Statement of Cash Flows: A Review Study

Mr. Venkatesh Ashokababu
Assistant Professor, Masters In Business Administration, Presidency University, Bangalore, India,
Email Id:- ashokababu@presidencyuniversity.in

ABSTRACT

The statement of cash flows is a crucial financial statement that provides valuable insights into an entity's cash inflows and outflows over a specific period. This abstract explores the purpose, structure, and significance of the statement of cash flows. It discusses the three main categories of cash flows: operating activities, investing activities, and financing activities. Additionally, it highlights the importance of analyzing the statement of cash flows to assess an entity's liquidity, cash management, and ability to generate future cash flows. The statement of cash flows serves as a complement to the income statement and balance sheet, offering a comprehensive view of an entity's cash flow activities. Its primary purpose is to provide information about the sources and uses of cash during a specific reporting period, enabling stakeholders to evaluate an entity's ability to generate cash and its cash management practices.

KEYWORDS

Cash Outflows, Direct Method, Indirect Method, Net Cash, Non-Cash Activities, Operating Activities.

I. INTRODUCTION

The statement of cash flows is the third crucial financial statement, after the balance sheet and the income statement. It was once known as the sources and uses of money statement, which more accurately describes the data it holds. It briefly explains how the business produced the cash flows necessary to fund its different financial obligations and possibilities during the last year. The statement of monies' sources and usage. As you read it, take note of the line items that show on the balance sheet in the "Changes" column. The sources and uses of money statement, which in this example compares 2016 and 2015, explains the changes in the balance sheets between the two subsequent years. In this case, what we'll do is:

1. Explain the process used to arrive at each, citing the balance sheet line item from which it originated.
2. Restate the s from the cash flow statement.
3. Examine the information that the statement of cash flows does and does not give.

Funding Sources

Profits from the business are a significant source of funding. Consequently, net income is usually presented first. This serves as the income statement's "bottom line," which may be seen in Exhibit 2-1 at line 31. Additionally, it has a significant impact on the retained profits on the balance sheet. Retained earnings rise as a result of net income. Retained profits drop when cash dividends are paid [1]–[3].

Depreciation costs came to $56,000

This item would be preceded by the heading, "Add Back Items Not Requiring the Disbursement of Cash," in a more official version of this statement. The justification for this is connected to the discussion of costs and outlays in 1. A cost item that did not need a cash outlay during the period and will never require one was deducted when calculating net income. Depreciation expenditure is the item. Capital expenditures, which are what this charge is connected to, have already been made. For two reasons, the depreciation charge was deducted on line 28. First of all, this is required under widely recognized accounting standards. Second, incorporating depreciation expenditure offers tax advantages since it is deductible as an expense for corporate income tax reasons. Although there was not a "real" deduction during this time period in terms of cash flow, it is brought back for the sources and uses of funds statement.

II. DISCUSSION

Increase in Bank Notes, $130,000

Metropolitan Manufacturing Company acquired an extra $130,000 in short-term bank funding during the year. This was in addition to the $170,000 in short-term bank debt it already had. Take note of the fact that Metropolitan Manufacturing Company increased both its short-term and long-term debt levels. The long-term sum that was paid off was not due by definition. "Current share of long-term debt," which is a current obligation, is how it would have been categorized if it had been due. There are several possible justifications for this funding method, but it was likely connected to the disparity between short- and long-term interest rates. Metropolitan most likely took out a short-term loan with a lower interest rate and used part of the money to pay off a higher interest long-term credit.

$110,000 more in accounts payable

When a business purchases goods and services on credit, the provider finances the transaction while still providing the product or service; however, payment is not made at the time of purchase. An overall rise in accounts payable indicates that the firm is more heavily dependent on its suppliers for funding. This is not a critique of the practice of making purchases on credit, which entails asking sellers to finance purchases or give customers long payment terms in order to get inexpensive cash. It is basically a declaration that the quantity of accounts due is more than it was before in an accounting report like this one. The following acts may cause an increase in accounts payable [4]–[6]:

1. paying payments later than usual
2. purchasing additional items using credit
3. paying more for products made using credit
4. An increase of $39,000 in other current liabilities

A liability's growth is a source of cash. Since accruals and comparable items make up the majority of this category, it inevitably grows every year as the business expands.

Investments fall down by $3,000

For $3,000, the business sold a few investments that were recorded. Bonds, long-term certificates of deposit, or maybe the common stock of another company were possible investments.

Funds' Uses

$34,000 was spent by the business to increase its fixed assets. The rise in the gross book value of fixed assets serves as evidence for this. The sole reason for a rise in gross book value is the acquisition of additional fixed assets since assets are reported at the lesser of cost or market value. Remember that the financial statements never reflect better economic worth, even if the older fixed assets here, such real estate, rose in economic value.

Inventory growth of $298,000

Even if inventory is restocked and sold often during the year, on a net basis, Metropolitan has added $298,000 to its inventory investment. Any combination of the following factors might contribute to the rise in inventory:

1. The cost of what was sold was more than the cost of replacement.
2. The price per unit bought has not changed, however there are now more units in stock.
3. The mix of available goods has shifted in favor of costlier goods.

This inventory s alone cannot tell us if inventory grew as a result of excessively optimistic sales predictions or underwhelming actual sales. We are unsure if this increase in inventory was due to a rise in raw materials, work in progress, or completed items. These problems will need analysis. The financial investment in inventories has grown, and that is the one thing that is definite.

The opposite is also possible. 2014 saw a sharp decline in the amount of inventories shown on the balance sheets of oil firms. Due to an oversupply of oil on the market, the amount of oil in stock actually grew. The price reductions of 50% that were sustained led to a dollar decline on the balance sheets.

1. $40k more in increased receivables
2. This extra sum has been "invested" by the corporation in funding its clients. One or more of the following factors might lead to this:
3. increased levels of sales, either as a result of higher pricing or larger volumes

4. Giving consumers longer credit terms so they have more time to pay
5. a decline in collecting efficiency

Offering credit terms to clients is a marketing investment that the business believes will result in more satisfied customers who buy more goods. However, failing to enforce such credit agreements is an indication of either accounting negligence or a poor market [7]–[10].

$50,000 less in long-term debt

$50,000 was utilized by Metropolitan Manufacturing Company to pay off its debt over the long term. The accounting standards provide convincing proof that this was a voluntary action. By definition, long-term debt has a maturity date that is not this year. This sum would have been categorized as a current obligation, most likely as a current portion of long-term debt, if it were due, as was noted in the discussion of the rise in short-term bank debt. This payment may have been paid for any one or more of the following reasons:

1. The long-term loan has a hefty interest rate.
2. The business had excess money.
3. The corporation put the money from the cheaper short-term bank loan to use.

On the open market, the long-term debt was being sold below par value. On the profit and loss statement, the difference between par and the sum paid to purchase it back at a discount is shown as other revenue.

$46,000 is paid out in cash dividends.

The Metropolitan Manufacturing Company's board of directors decided to distribute $46,000 in cash dividends to the owners of preferred and regular shares. Traditionally, but not always, such dividends are approved and paid out on a quarterly basis.

Cash Flow Statement

The more analytical approach that we supplied here is not the one that generally accepted accounting rules need for this information. This structure, known as the statement of cash flows, is used in almost every other firm whose financials are prepared and compiled by certified public accountants as well as in all published annual reports of public corporations. Three s are used to convey the information:

Cash flow from operations given or consumed Cash flows from investments or their usage Cash flows that are utilized or given for financing Since the majority of financial information is accessible in this format, it is crucial to be acquainted with and comprehend it. Keep in mind that sources of cash aren't represented with Cash Flow, whereas uses of funds are shown with parenthesis to indicate outflow. Operation's contribution Slowing down supplier payments may help with cash flow. Accounts payable growth represents a cash inflow. Is this actually an improvement in performance if the firm defers paying its suppliers until far later than the agreed-upon payment terms? No, we believe. To "increase" cash flow from operations, the corporation is skipping profi cash discounts, harming its relationships with suppliers, and running the risk of not getting merchandise on schedule.

The amount of net income includes interest income from short-term investments. It is clear that this is not cash flow from operations. Operations refers to the company's business, the production and sale of goods. By holding onto cash rather of investing it in the requirements of the firm, such as purchasing equipment or employing more salespeople, the corporation might seem to be boosting its operational cash flow. The category "other income and ex- penses" of net income also includes gains from asset sales. Selling underperforming assets and companies is undoubtedly a good strategy, and doing so may undoubtedly provide significant cash flow. However, this barely qualifies as cash flow from operational activities. The amount of net income also includes loan interest costs. It would be more accurate to classify this cash outflow as a financing activity as opposed to an operation. The traditional definition of free cash flow is:

Flow of Cash from Operations Absent: Capital Spending the same as free cash flow. Analysts often use this term, which has the meaning of "discretionary cash flow," to describe how much money a firm has available to take advantage of professional, market-penetrating possibilities. This is not true at all and needs to be questioned. According to this criterion, capital expenses are given a greater priority than debt payments. Capital expenditures are undoubtedly less important than paying the needed debt payment. It's comparable to redoing your kitchen and then being unable to pay your mortgage. This statistic encourages the business to forego making critical changes, hence lowering capital expenditures, in order to "improve" free cash flow and "look better."

Here is a revised statement of cash flows that is more helpful for Metropolitan Manufacturing Company. Unfortunately, it does not follow generally accepted accounting rules, or the all-powerful GAAP, and is unlikely to be included in audited financial statements. However, keep in mind that this is not an accounting discussion. "Accounting regulations" are not a constraint on us since we are assessing the company.

We suggest the following adjustments to the free cash flow formula:

Step 1: "Cash Flows Provided by Operations" includes net income as follows:

Take interest income away. It is then included in cash flows from investment operations. Investments include purchasing interest-bearing instruments like Treasury securities or CDs. While doing so is useful, it is not a "operating activity" since it is not a "regular" aspect of operations. Subtract interest costs. Borrowing is a kind of finance. A financing expenditure is also the cost of paying interest on the borrowed monies. It is included into the finance activity cash flows. Eliminate profits or losses from asset sales. This is a kind of investment. It should only happen once, yet this is often not the case.

Step 2: Subtract changes in accounts payable from Cash Flows Provided by Operations as a whole. Accounts Payable, which should be included in cash flows from financing operations, is funding received from suppliers for goods and services that have been acquired.

Then, free cash flow would be:

1. Flows of Cash from Operating Activities
2. Minus: A Better Version of Free Cash Flow Is: Cash Flows for Debt Service

Please understand that we are not criticizing the accounting profession's preferred format. Never again do we want to get into that debate. In order to examine our company, we try to create information that is helpful. Measuring a company's financial health allows us to make wise management choices, which is the purpose of a statistic like the statement of cash flows. The updated form shown here does that better.

A Review and Update of Generally Accepted Accounting Principles

In the introduction, the Financial Accounting Standards Board's function was briefly discussed. The majority of the members of this research group are accountants. Over time, the FASB and the broader accounting industry developed a set of guidelines known as generally accepted accounting principles. The FASB also releases publications known as FASB Bulletins. These are a collection of more than a hundred publications that outline ideal company reporting practices. The majority of these methods have been used and are now part of standard accounting practice. A general comparison would be that the bulletins are proposed revisions, while the GAAP standards are the fundamental law. Here are some basic GAAP guidelines.

The Fiscal Period

For predefined amounts of time, all reporting is completed. Reports may be published for months, quarters, or even yearly intervals in certain cases. Calendar periods and accounting fiscal periods often align, albeit not always with the same year. A few businesses specify that their calendar year is made up of 13 months and their fiscal month is 28 days. Other businesses could use a fiscal year of, instance, February 1 through January 31 or July 1 through June 30. Municipal governments schedule the start of their fiscal years to occur three months after the start of the corresponding state governments' fiscal years. This allows the municipality three months to decide how much state help they will get before the local government's deadline. The fiscal year for state governments begins three months after the fiscal year for the federal government. In a similar vein, this gives the state three months to find out what federal assistance will be available before the state budget deadline.

The Concept of a Going Concern

The assumption made by accountants while maintaining the books and creating the financial statements is that the firm will be there for the foreseeable future. The financial accounts will be published at estimated liquidation value if there is substantial question about this or if the company's ending operations is a foregone conclusion. The outside CPA firm is obligated to remark on the financial status of the business in its certification letter to shareholders if it is experiencing substantial financial difficulties and its ability to continue operating is in question. It must issue a clear declaration in which this concern is stated in full.

Financial Unit of the Past

Accounting is the process of documenting previous financial company activities. Financial statements and, in fact, all financial accounting in the United States report solely in dollars. Although inventory units, market share, and staff productivity are important business concerns, reporting on them is beyond the purview of financial accounting. Past financial statements are given in the order in which they happened. Although reports from earlier eras are not updated to take into account the current state of the economy, the selling prices of the items and the value of the assets may very well alter today.

Conservatism

According to conservatism, "good news" is only acknowledged after the event has really taken place, whereas "bad news" must be acknowledged as soon as the condition becomes probable and the quantity can be calculated.

The provision for bad debts on the balance sheet, which is documented before the losses are actually incurred, is one example of this. It is acknowledged that the corporation may not be able to collect on all of its accounts receivable. Before the business determines which clients truly won't pay their bills, the entire amount of uncollectible accounts receivable is calculated, and the allowance is recorded. Another example is the reserves for inventory write-downs, which are recorded prior to the products being actually put up for sale at distress prices. These products may be outdated or out-of-style. On December 26 it becomes obvious that any Christmas things still in stock must be sold at steep discounts. Rather than when the goods are actually placed up for sale, the write-down is recorded on December 26. However, a refund is not recorded until the goods is really delivered or the service is actually rendered to the consumer, regardless of how assured its receipt may appear from a commercial perspective. While improving the commercial certainty of the transaction, payment in advance does not alter the accounting norm. Only when it is earned is revenue reported.

Quantifiable Transactions or Items

In a commercial sense, a company's valuable personnel and the information its people hold may be its crucial competitive advantage. However, accounting does not classify that value as an asset since it cannot be measured and stated in monetary terms. In most cases, the value of trademarks and domain names is also excluded. Coke, Windows, and Disney are unquestionably well-known brand names. Although a franchise name may have an almost limitless economic value if it is maintained, the name is not shown as an asset on the balance sheet since it is impossible to determine its exact worth.

Consistency

When putting up a company's financial statements, accountants have several choices to choose. These include, but are not limited to, deciding on the depreciation schedule for fixed assets and whether to account for inventories using LIFO or FIFO. However, once these choices have been taken, every subsequent set of financial statements must use the same approach. The accountants must emphasize any significant changes in accounting approach and revise earlier financial statements to reflect them. Comparative analysis and trends are only reliable after that. We don't want changes in accounting methodology to affect the examination of two sets of financials that come after one another. Additionally, if the accounting system from the preceding year has changed, it will read "restated" just above those numbers. There will likely also be a footnote providing a more thorough description of the changes if the changes are important.

Full Transparency

Accountants must take action to ensure that readers of the financial statements are fully informed of any significant changes to the accounting approach and how those changes influenced the financial performance.

Materiality

An occurrence that is substantial or noteworthy may have an impact on the reader's interpretation, judgment, or perception of the information. Events deemed to be significant must be stated individually and emphasized appropriately. This idea is illustrative. Something important in a business with $20 million in yearly sales could be entirely meaningless in one with billions of dollars in sales.

III. CONCLUSION

In conclusion, a crucial financial document that details an entity's cash inflows and outflows is the statement of cash flows. It provides information on a company's liquidity, cash management methods, and capacity for

producing future cash flows. Stakeholders may analyze an entity's financial health, make wise investment choices, and determine its cash flow sustainability by analyzing the statement of cash flows. In determining an entity's capacity to produce future cash flows and fulfill its financial commitments, the statement of cash flows is also helpful. Stakeholders may assess the quality of profits and how much net income is converted into cash by comparing cash flows from operational operations to net income. Identifying possible liquidity problems, such as an excessive dependence on financing activities or a persistently negative cash flow trend, may also be done by looking at total cash flow trends and patterns.

REFERENCES

[1] A. G. Arnold, R. Barry, and E. V. S. Krishnan, “Toward effective use of the statement of cash flows,” J. Bus. Behav. Sci., 2018.

[2] Z. Gao, W. Li, and J. O’Hanlon, “The informativeness of U.S. banks’ statements of cash flows,” J. Account. Lit., 2019, doi: 10.1016/j.acclit.2019.03.001.

[3] P. D. S. Costa, A. F. Pinto, F. M. Nunes, and S. Lemes, “Comparability of accounting choices in the statement of cash flow: Evidence from Brazil,” Contaduria y Adm., 2019, doi: 10.22201/fca.24488410e.2019.1445.

[4] L. Hodder, P. E. Hopkins, and D. A. Wood, “The effects of financial statement and informational complexity on analysts cash flow forecasts,” Account. Rev., 2008, doi: 10.2308/accr.2008.83.4.915.

[5] F. Petro and F. Gean, “A Logical Approach To The Statement Of Cash Flows,” Am. J. Bus. Educ., 2014, doi: 10.19030/ajbe.v7i4.8845.

[6] D. D. Nguyen and A. H. Nguyen, “The impact of cash flow statement on lending decision of commercial banks: Evidence from Vietnam,” J. Asian Financ. Econ. Bus., 2020, doi: 10.13106/JAFEB.2020.VOL7.NO6.085.

[7] M. Ayoub, W. Jammoul, and S. Mekdessi, “International Accounting Standard 7 – Statement of Cash flows – Compared to the Lebanese General Accounting Plan,” IOSR J. Bus. Manag., 2017, doi: 10.9790/487x-1906060108.

[8] B. Miao, S. H. Teoh, and Z. Zhu, “Limited attention, statement of cash flow disclosure, and the valuation of accruals,” Rev. Account. Stud., 2016, doi: 10.1007/s11142-016-9357-z.

[9] M. Pavlovic and J. Bogdanovic, “Cash flow statement,” Sk. biznisa, 2013, doi: 10.5937/skolbiz1304129p.

[10] B. Baik, H. Cho, W. Choi, and K. Lee, “Who classifies interest payments as financing activities? An analysis of classification shifting in the statement of cash flows at the adoption of IFRS,” J. Account. Public Policy, 2016, doi: 10.1016/j.jaccpubpol.2015.11.003.