STRUCTURE OF THE CASH FLOWS STATEMENT

Khalilov Bahromjon Bahodirovich
Asia International University, Bukhara
Lecturer of department of Economics

Abstract: *This article provides a practical analysis of the practical application of a cash flows statement and the problems in the transition to international financial reporting standards and ways to overcome them.*

Keywords: *international financial reporting, a cash flows statement, international financial reporting standards, business, equity, investment.*

An important component of manager–owner communication is the firm's financial statements. Firms organized as proprietorships or partnerships are not required to prepare financial reports or statements except for tax purposes. Of course, proprietors and partners must gather financial data so as to be able to evaluate their financial performance over time. Requests for bank loans need to be accompanied by recent financial statements, too. In contrast, companies organized as corporations are required to prepare financial reports annually for the benefit of their shareholders. Public corporations are required to fi le annual reports with the SEC. An annual report contains descriptive information on operating and financial performance during the past year, a discussion of current and future business opportunities, and financial statements that provide a numerical record of financial performance. Usually, financial highlights are provided on the first page or two, followed by a letter to the stockholders by the fi rm's chairman of the board and chief executive officer (CEO). The CEO summarizes the financial results for the year and identifies the fi rm's strengths, such as employee talents and the size of its customer base. After the CEO's letter, most companies describe their current business areas, future opportunities, and financial goals, such as a target return on equity or earnings growth rate.

A statement of cash flows provides a summary of the cash inflows (sources) and cash outflows (uses) during a specified accounting period. The statement consists of three sections: operating activities, investing activities, and financing activities. The primary approach to constructing a statement of cash flows begins with the net income from the income statement as a cash inflow. We add back any noncash deductions, such as depreciation, which were deducted by accounting principles although no cash outflow occurred. The other "cash flow" adjustments are made by examining the differences in the accounts from two consecutive balance sheets. More specifically, cash flows are determined as follows:

Sources

1. Amount of net income plus amount of depreciation
2. Decrease in an asset account
3. Increase in a liability account
4. Increase in an equity account

Uses

1. Increase in an asset account
2. Decrease in a liability account
3. Decrease in an equity account
4. Amount of cash dividends

Changes in the cash account are excluded. In the statement of cash flows, all of the fi rm's sources and uses of cash are added together. Their sum equals the change in the firm's cash account. If the statement of cash flows is constructed correctly, the sum of the items should equal the difference in the cash account between the two balance sheets used to generate it. Let's examine these more closely:

• Assets. The purchase of raw materials or an increase in the amount of finished goods held requires additional cash. Thus, it is a use and is, therefore, subtracted in the statement of cash flows. In contrast, collections of accounts receivable frees up cash; the reduction in accounts receivable is a source and is added in the statement of cash flows.

• Liabilities and equity. Borrowing money from a bank or receiving an added investment from a partner or stockholder represents a source of cash to the firm. In contrast, paying off a bank loan or repurchasing shares of stock is a use of cash.

All businesses have owners' equity in one form or another. Owners' equity is the investment of the owners or owner in the business. It initially results from a cash outlay to purchase assets to operate the business. In some cases, the owners of a business may place their own assets, such as machinery, real estate, or equipment with the fi rm for its operation. In addition to contributing cash or property, owners' equity may be increased by allowing profits to remain with the business. On the balance sheet, the amount of owners' equity is always represented by the difference between total assets and total liabilities of the business. It reflects the owners' claims on the assets of the business as opposed to the creditors' claims. In the case of a corporation, the owners' equity can be broken down into three different accounts. First, companies has no preferred stock outstanding, so the preferred equity or stock account balance is zero. Second, the common stock, or common equity, account reflects the number of outstanding shares of common stock carried at a stated or par value and the capital paid in excess of par. The par value is an arbitrary value and, therefore, is not related to a fi rm's stock price or market value. Some firms have "no par" common stock, meaning the common stock has a par value of $0. The third account is called the retained earnings account, and it shows the accumulated undistributed earnings (i.e., earnings not paid out as dividends) of the corporation over time. These retained earnings do not represent cash. They have been invested in the firm's current and/or fixed assets over the firm's lifetime. Together, these three accounts (preferred equity, common equity, and retained earnings) comprise the corporation's stockholders' equity.

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