Changes in financial position

Objective :

1. Describe theinformation provided in a statement in financial position and classify the cash flows of a company as operting, investing, or financing activities.
2. Identify for reporting on the Statement of Changes in financial Position (SCFP) any simultaneous investing and financing transactions.
3. Calculate cash flows and outflows by inspecting the noncash account balances of a company and related information aboutits transactions.
4. Calculate the net cash provided or used by operating activities according to the direct approach and prepare the SCFP.
5. Prepare a working paper to identify changes in account balances and classify these changes as operating, investinf, or financing activities.

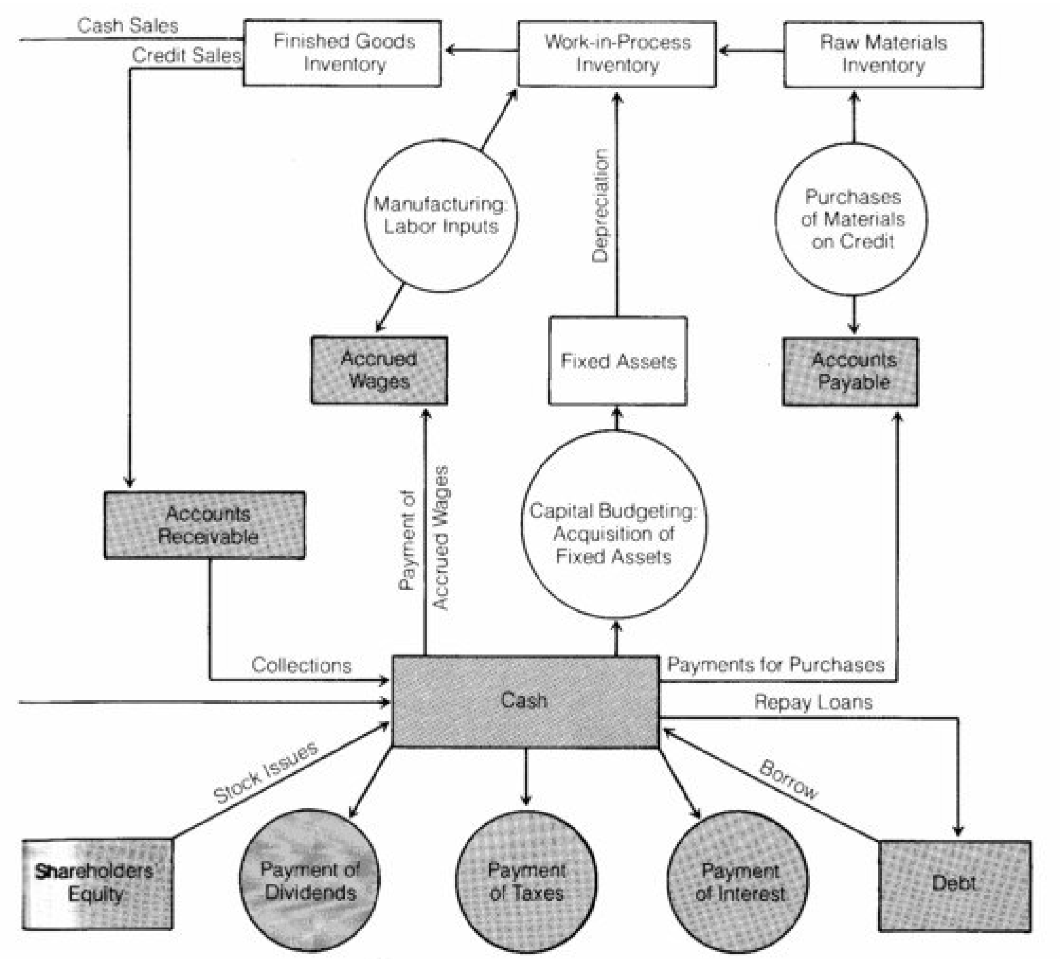
The cash flow cycle

Rectangles represent balance sheet accounts—assets and claims against assets—while circles represent actions taken by the firm.

Each rectangle may be thought of as a reservoir, and you can visualize a wawy line which designates the amount of the asset or liability in the reservoir (account) on a balance sheet date.

Various transactions would cause changes in the accounts, just adding or substracting water would change the level in a reservoir.

Cash and materials flows within the firm.



The cash account is the focal point of the graph. Certain events, such as collecting accounts receivable or borrowing money from the bank, will cause the cash account to increase, while the payment of taxes, interest, and so on willcause the cash account to decline.

Why cash flow information is important?

Information about cash flows can influence decision makers in many ways:

1. If a company's regular operations bring in more cash than they use, investors willvalue the company higher than if property and equipment must be sold to finance opertions.

2. Information about cash flows can help creditors decide whether a company will have enough cash to pay its existing debts as they mature.

3. Investors, creditors, maangers, and other users of financial statements use cash flow information to evaluate a company's ability to meet unexpected obligations.

4. Cash flow information is also used to evaluate a company's ability to take advantage of new business opportunities that may arise.

The information needed to prepare a SCFP comes from a variety of sources:

1. a comparative balance sheets at the beginning and the end of the accounting period;
2. an income statement for the period;
3. a careful analysis of each noncash balance sheet account in the general ledger.

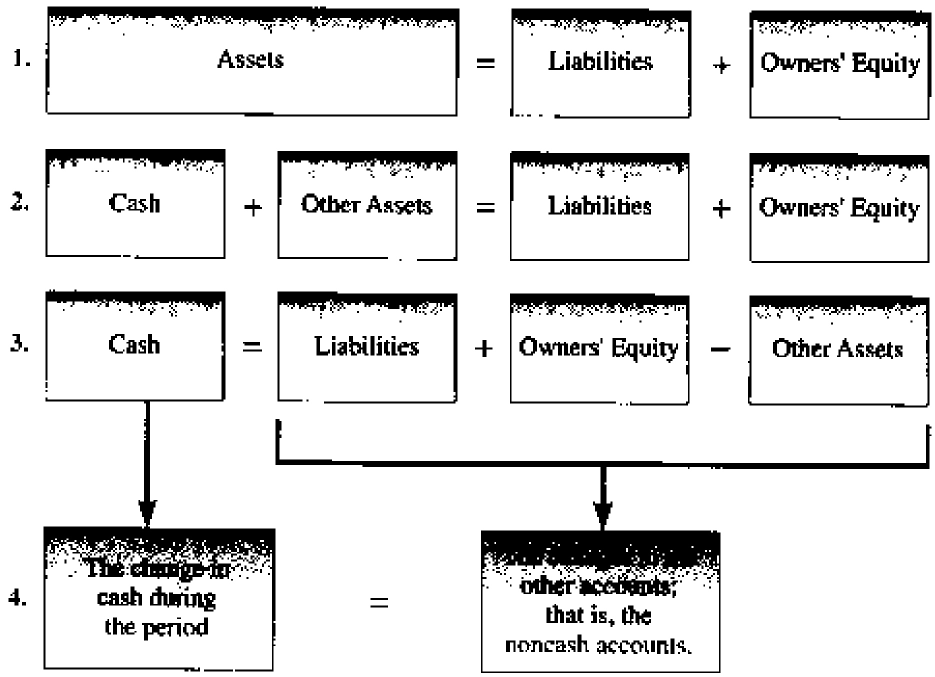
However, because cash inflows and cash outflows are to be reported, you might wonder why we do not focus our attention on the cash account.

While an nalysis of the cash account may appear to be an easy way to prepare and SCFP, it has two serious drawback.

1. Most companies have so many individual cash receipts and disbursements that it is not practical to review them all.
2. the cash account usually does not contain a description of each cash transaction. Thus the cash account does not readily provide the information neded to prepare an SCFP.

Analyzing noncash accounts to determine cash flows

Why an Analysis of the Noncash Accounts Explains the Change in Cash



Therefore we can determine the nature of the cash inflows and outflows by examining the changes in the non cash balance sheet accounts.

When beginning to analyze the changes in the noncash balance sheet accounts, recall that retained earnings, is affected by revenues, expenses, and dividend declarations. Therefore, look at the income statement accounts to help explain the change in retained earnings.

Key Relationships between Income Statement Items and Balance Sheet Accounts

Income Statement Items	Related Balance Sheet Accounts	Possible Cash Flow Effects
Sales	Accounts receivable	Cash receipts from customers
Cost of goods sold	Merchandise inventory, accounts payable	Cash payments to suppliers
Amortization expense	Accumulated amortization	None
Operating expenses	Prepaid expenses, accrued liabilities	Cash payments for operating expenses
Gain or loss on sale of plant assets	Plant assets, accumulated amortization, notes receivable	Cash receipts from sale of plant assets
Gain or loss on retirement of bonds payable	Bonds payable, premium or discount on bonds payable	Cash payments for retirement of bonds

If the accounts receivable balance did not change, the cash collected from customers is equal to sales revenue.

On the other hand, if the accounts receivable balance decreased, cash collections must have been equal to sales revenue plus the reduction in accounts receivable.

And if the accounts receivable increased, the cash collected from customers must have been equal to sales less the increase in accounts receivable.

Preparation of SCFP: the direct approach.

GROVER COMPANY
Balance Sheet
December 31, 1993 and 1992

	1993		1992	
Assets				
Current assets:				
Cash		$ 17,000		$ 12,000
Accounts receivable		60,000		40,000
Merchandise inventory		84,000		70,000
Prepaid expenses		6,000		4,000
Total current assets		$167,000		$126,000
Long-term assets:				
Plant assets	$250,000		$210,000	
Less: Accumulated amortization	60,000	190,000	48,000	162,000
Total assets		$357,000		$288,000
Liabilities				
Current liabilities:				
Accounts payable		$ 35,000		$ 40,000
Interest payable		3,000		4,000
Income taxes payable		22,000		12,000
Total current liabilities		$ 60,000		$ 56,000
Long-term liabilities:				
Bonds payable		90,000		64,000
		$150,000		$120,000
Shareholders' Equity				
Contributed capital:				
Common shares	$ 95,000		$ 80,000	
Retained earnings	112,000		88,000	
Total shareholders' equity		207,000		168,000
Total liabilities and shareholders' equity		$357,000		$288,000

Income Statement
For Year Ended December 31, 1993

Sales		$ 590,000
Cost of goods sold	$300,000	
Wages and other operating expenses	216,000	
Interest expense	7,000	
Income taxes expense	15,000	
Amortization expense	24,000	(562,000)
Loss on sale of plant assets		(6,000)
Gain on retirement of debt		16,000
Net income		$ 38,000

Here is the analysis
There are three types of activities that we will be following:

1. operating activities
2. investing activities
3. financing activities

Operating activities

Three types of adjustments

1. changes in non cash current assets and current liabilities that relate to operating activities
2. changes that relate to operating activities that did not involve a cash inflow or outflow during the period.
3. adjustment that eliminate to gains or losses that resulted from investing and financing activities. These gains and losses do not relate to operating activities.

Reconciliation of Net Income to Cash Flows from Operating Activities

Net Income or Net Loss

Plus	**Minus**
Decreases in noncash current assets. Increases in current liabilities.	Increases in noncash current assets. Decreases in current liabilities.
Expenses which do not require a cash outflow during the period.	Income which did not result in a cash inflow during the period.
Losses from investing and financing activities.	Gains from investing and financing activities.

Investing activities

Transactions that involve making and collecting loans or that involve purchasing and selling capital assets, other productive assets, or investments.

Usually, investing activities involve the purchase or sale of assets classified on the balance sheet as capital assets, i.e. plant and equipement and intangible assets, or long-term investments.

Cash Flows from Investing Activities

Cash Inflows	Cash Outflows
Proceeds from selling productive assets (e.g., land, buildings, equipment, natural resources, and intangible assets).	Payments to purchase property, plant, and equipment or other productive assets (excluding merchandise inventory).
Proceeds from selling investments in the equity securities of other companies.	Payments to acquire equity securities of other companies.*
Proceeds from selling investments in the debt securities of other entities, except cash equivalents.	Payments to acquire debt securities of other entities, except cash equivalents.
Proceeds from collecting the principal amount of loans	Payments in the form of loans made to other parties.
Proceeds from the sale (discounting) of loans made by the enterprise.	

* Excluding those securities which are cash equivalents.

Financing activities

These activities include transactions with its owners and transaction with creditors to broow money or to repay the principal amounts of loans.

Financing activities include borrowing and repaying both short-term loans and long-term debt.

Cash Flows from Financing Activities

Cash Inflows	Cash Outflows
Proceeds from issuing equity securities (e.g., common and preferred shares).	Payments of cash dividends and other distributions to owners.*
Proceeds from issuing bonds and notes payable.	Repayments of cash loans.
Proceeds from other short- or long-term borrowing transactions.	Payments of the principal amounts involved in long-term credit arrangements.

* Some companies treat dividends as an operating activity outflow, while others disclose them in a separate category. Section 1540 of the *CICA Handbook* requires that dividends be disclosed but does not offer any guidance as to their category in the SCFP.

Grover Company: A comprehensive example. Grover Company's balance sheets and its 1993 income statement are presented earlier. Our objective is to prepare an SCFP that explains the $5 000 increase in cash, based on the financial statements and this additional information about the 1993 transactions:

a. Net income was $38,000.
b. Accounts receivable increased by $20,000.
c. Merchandise inventory increased by $14,000.
d. Prepaid expenses increased by $2,000.
e. Accounts payable decreased by $5,000.
f. Interest payable decreased by $1,000.
g. Income taxes payable increased by $10,000.
h. Amortization expense was $24,000.
i. Loss on sale of plant assets was $6,000: assets that cost $30,000 with accumulated amortization of $12,000 were sold for $12,000 cash.
j. Gain on retirement of bonds was $16,000: bonds with a book value of $34,000 were retired with a cash payment of $18,000.
k. Plant assets that cost $70,000 were purchased; the payment consisted of $10,000 cash and the issuance of a $60,000 note payable.
l. Sold 3,000 common shares for $15,000.
m. Paid cash dividends of $14,000.

Let's take them one by one.

GROVER COMPANY
Net Change in Cash—Direct Approach
For Year Ended December 31, 1993

	December 31 1993	December 31 1992	Increase (Decrease)
Cash flows from operating activities:			
Net income for 1993 (*a*)			$ 38,000
Adjustments to reconcile net income to cash provided by operating activities:			
1. Accounts receivable (*b*)	$60,000	$40,000	(20,000)
Merchandise inventory (*c*)	84,000	70,000	(14,000)
Prepaid expenses (*d*)	6,000	4,000	(2,000)
Accounts payable (*e*)	35,000	40,000	(5,000)
Interest payable (*f*)	3,000	4,000	(1,000)
Income taxes payable (*g*)	22,000	12,000	10,000
2. Amortization expense (*h*)			24,000
3. Loss on sale of plant assets (*i*)			6,000
Gain on retirement of debt (*j*)			(16,000)
Net adjustments			(18,000)
Cash provided by operating activities			20,000
Cash flows from investing activities:			
Cash received from sale of plant assets (*i*)			12,000
Cash paid for purchase of plant assets (*k*)			(70,000)
Net cash provided by investing activities			(58,000)
Cash flows from financing activities:			
Cash received from share issue (*l*)			15,000
Cash received from note issue (*k*)			60,000
Cash paid to retire bonds (*j*)			(18,000)
Cash paid for dividends (*m*)			(14,000)
Net cash provided by financing activities			43,000
Net increase in cash			$ 5,000

Exercise

Given the following condensed income statement and a partial list of account balances, calculate the cash provided by operating activities:

BUTTERFIELD COMPANY
Income Statement
For the Year Ended December 31, 1993

Sales		$225,000
Cost of goods sold		130,000
Gross profit from sales		$ 95,000
Operating expenses:		
Salaries and wages	$31,250	
Amortization expense	3,750	
Rent expense	9,000	
Amortization of patents	750	
Office expense	1,000	
Bond interest expense	3,375	49,125
Net income		$ 45,875

Butterfield Company's partial list of comparative account balances as of December 31, 1993 and 1992:

	1993	1992
Cash	$ 2,600	$ 2,200
Accounts receivable (net)	23,200	21,800
Inventory	17,900	19,300
Prepaid expenses	1,200	1,400
Accounts payable	11,400	12,100
Salaries and wages payable	250	650
Interest payable	1,500	750
Unamortized bond discount	500	875