STATEMENT OF CHANGES IN FINANCIAL POSITION

by

Dr. J. Herbert Smith/ACOA Chair
Technology Management and Entrepreneurship
Faculty of Engineering
University of New Brunswick

Contents Next

CONTENTS - STATEMENT OF CHANGES IN FINANCIAL POSITION

- **Learning Objectives**
- **Statement of Changes in Financial Position - Introduction**
- **Business Activities affecting Cash Flow**
- **Cash and the Accounting Equation**
- **Sources and Uses of Cash**
    - Operating Activities
    - Investing Activities
    - Financing Activities
- **Net Cash Flow**
- **Summary**

LEARNING OBJECTIVES

When you have completed this module, you will be able to:

- Identify the typical structure and content of the Statement of Changes in Financial Position.
- Correctly apply commonly used financial terms used in the Statement of Changes in Financial Position.
- Correctly identify and interpret a company's sources and uses of cash during an accounting period - i.e. Where does the cash come from, what do they use it for?
- Identify issues related to the financial health of a company by examining the sources and uses of cash.

Previous Contents Next

Statement of Changes in Financial Position

This statement (also referred to as the Cashflow Statement) reports the amount of cash coming in (cash receipts) and the amount of cash going out (cash payments or disbursements) during a specified period. Business activities result in either a net cash inflow (receipts greater than payments) or a net cash outflow (payments greater than receipts) during a period. The cash flow statement shows the net increase or decrease in cash during the period and the cash balance at the end of the period. It explains the causes for the changes in the cash balance. The cash flow statement covers a span of time.

Purpose:

- To provide information about the operating, financing and investing activities of the enterprise and the effect of those activities on cash resources;
- To tell how much cash came in during the period, how much cash went out during the period and what the net cash flow was during the period.

The three financial statements are very closely linked and they complement each other in providing financial insights into a company. No picture of the cash "position" would be complete by looking at only one of these statements, but it becomes clearer as you look at all of them.

- A Balance sheet reports the cash balance at the end of the period. By examining two consecutive Balance sheets, you can tell whether cash increased or decreased during the period. The Balance sheet however would not indicate why the cash balance changed.
- The Income statement reports revenues, expenses and net income. These would be clues about the sources and uses of cash, but it would not tell why cash increased or decreased.
- The cash flow statement reports the entity's cash flows during the period, outlining where cash came from and where it was spent. It explains the causes for the change in the cash balance.

Business Activities affecting Cash Flow

A business may be evaluated in terms of three types of business activities. After the business is operational, operations are the most important activity, followed by investing activities and then financing activities.

- Operating activities create revenues and expenses. The largest cash inflow from operations is the collection of cash from customers. Operating cash outflows include payments to suppliers. The cash flow statement reports the impacts of the revenues and expenses on cash.
- Investing activities increase and decrease the long term assets available to the business. A purchase or sale of a capital asset like land is an investing activity.
- Financing activities obtain the funds from investors and creditors needed to launch and sustain the business. Financing activities include issuing stock, borrowing money by issuing notes and bonds payable, and making payments to shareholders.

These sources and use of cash and how they fit into the statement of changes in financial position will be further addressed later in the module.

*Click on the play button to hear the audio

Audio Transcript

Previous Contents Next

Audio Transcript

When we are looking at the income statement we are not looking at the cash flow of the company. Many companies might say, "we are very profitable, but don't have any cash". That is why understanding this Statement of Changes in Financial Position is so important in business because cash pays your bills, cash meets your payroll and it keeps your company rolling along. All companies experience negative cash flow from time to time. There is nothing wrong with negative cash flow, though in the long run you want to have positive cash flow.

So really what we are doing with the Statement of Changes in Financial Position is looking at all of the activities that take place within a firm that have an effect on cash. Normally, accountants categorize these activities as operating activities, investing activities and financing activities. Each of those three activities can cause cash to come in or cash to go out. The net result is that these activities cause a cash flow, positive or negative in a company.

Cash and the Accounting Equation

The foundation of the Statement of Changes in Financial Position is the fundamental accounting equation upon which the balance sheet is based. This equation is:

Assets (A) = Liabilities (L) + Shareholder's Equity (SE)

i.e. A = L + SE

Since this statement is all about cash, we want to isolate cash as a separate item. We know that cash is an asset. So if we want to isolate cash, then the way to do it is to take the Assets component and break it down into two parts - the cash portion of assets and all other assets that we have on the balance sheet such as accounts receivable, inventory and long-term assets etc.

Assets (A) = Cash (C) + Other Assets (OA)

i.e. A = C + OA

Previous Contents Next

Cash and the Accounting Equation (cont'd)

We noted that A = L + SE and we know that Assets (A) is comprised of Cash (C) and Other Assets (OA). In other words, cash + other assets, which equals total assets, equals total liabilities plus shareholders equity. Therefore,

C + OA = L + SE

We are now in a position where we can isolate cash by rearranging the equation and moving "other assets" to the right side. Cash is therefore equal to liabilities plus shareholder's equity, less other assets:

C = L + SE - OA

Therefore,

- if liabilities increase over a period and we want to sustain this equation, then cash must also go up. Conversely, when liabilities decrease, cash must decrease.
- an increase or decrease in shareholders equity also causes an increase or decrease in cash flow.
- because we sometimes need other assets other than cash, we use cash to buy these other assets causing an increase in other assets and decrease in cash.

Previous Contents Next

Sources and Uses of Cash - Operating Activities

Operating activities are activities that create revenue or expense in the entity's major line of business. The largest cash inflow from operations is the collection of cash from customers. A large positive operating cash flow is a good sign about a company, as in the long run, operations should be the main source of a business's cash.

Operating cash flow results from producing and selling the firm's goods and/or services and administering the functions of the firm (e.g. working capital management). Cash flow from operations is calculated by adjusting net income to reconcile net income to cash, taking into account such factors as changes in accounts receivable, inventory, accounts payable, etc. This is necessary because net income is not equivalent to cash flow for a variety of reasons.

A typical format would look like this:

Operating Activities

Net Income	XXX	(figures taken from Income Statement)
[Add (subtract) items that affect net income and cash flow]		
Depreciation	XX	(figures taken from Income statement)
(Increase)/Decrease in accounts receivable	XX	(figures taken from Balance sheet)
(Increase)/Decrease in inventory	XX	(figures taken from Balance sheet)
Increase/(Decrease) in accounts payable	XX	(figures taken from Balance sheet)
Increase/(Decrease) in wages payable	XX	(figures taken from Balance sheet)
(Extraordinary Gain/Loss) on sale of equipment	XX	(figures taken from Income Statement)
Total Adjustments	(XXX)	
Net cash provided by operations	XXX	

Example of Operating Activities as listed in a Cash Flow Statement

Statement of Changes in Financial Position
TME Corporation
For the Year Ended December 31, 1996

Operating Activities	1996
Net Income	$98,000
Adjustments to reconcile net income to cash:	
Depreciation	$21,000
(Increase)/Decrease in accounts receivable	($20,000)
(Increase)/Decrease in inventory	($40,000)
Increase/(Decrease) in accounts payable	($50,000)
Increase/(Decrease) in wages payable	$2,000
Gain on sale of equipment	($2,000)
Total Adjustments	($89,000)
Net cash provided by Operating Activities	**$9,000**

This section of the Statement of Changes in Financial Position for the TME Corporation for the year ended 31st December, 1996, shows the cash flow from operating activities. You can see that the net cash flow provided from operations was a positive $9,000, in other words - operations contributed surplus cash flow of $9,000. This $9,000 was calculated, as shown above, by reconciling the Net Income (figure brought in from the Income Statement) to Cash.

So even if the net income was $98,000, the cash flow from that $98,000 was only $9,000. The cash flowing from the operating activities was only positive $9,000 because inventory was purchased, trade credit was extendend, and noted other activities occured, all of which reduced the cash relative to what was collected.

*Click on the play button to hear the audio
Audio Transcript

Previous Contents Next

Audio Transcript

Cash flow from operations is calculated by adjusting net income to reconcile with cash, taking into account such factors as changes in accounts receivable, inventory, accounts payable and so on.

Remember, the income statement does not show us cash flow. So what we have to do is take that bottom line that shows up in the income statement, which shows up in the retained earnings part of the balance sheet under shareholders equity and using appropriate adjustments convert that back into cash flow.

Sources and Uses of Cash - Investing Activities

Investing activities are activities that increase and decrease the long-term assets available to the business.

Acquiring and/or divesting of land, buildings and equipment are examples of investing activities. Acquiring an interest in another company is also an investing activity. Buying and selling capital assets, making and collecting loans and buying and selling the securities of other firms are all investing activities.

A typical format would look like this:

Investing Activities

Proceeds from sale of equipment	XX
Purchases of equipment	(XX)
Increase)/Decrease) in cash from investing activities	XX

(outflows are normally shown in parenthesis to indicate that payments must be subtracted.)

Previous Contents Next

Example of Investing Activities as listed in a Cash Flow Statement

Statement of Changes in Financial Position
TME Corporation
For the Year Ended December 31, 1996

	1996
Operating Activities	**$9,000**
Investing Activities	
Proceeds from sale of equipment	$8,000
Purchases of equipment	($25,000)
Increase/(Decrease) in cash from Investing Activities	**($17,000)**

This section of the Statement of Changes in Financial Position shows the cash flow during the period from activities such as buying or selling assets, lending money to companies or investing money in companies. You can see from this statement that the operating activities produced a positive cash flow of $9,000. Note the two investing activities here that had an effect on cash were the sale of equipment that brought in a positive cash flow and the purchase of equipment which increased our assets, but most importantly for purposes of this statement decreased our cash. The net effect of these transactions is a decrease in cash of $17,000.

*Click on the play button to hear the audio
Audio Transcript

Sources and Uses of Cash - Financing Activities

Activities that obtain the funds from investors and creditors needed to launch and sustain a business are considered financing activities and include:

- Issuing and redeeming shares - Perhaps a company issued some shares, sold some shares to a private investor and raised some share capital. This is a financing activity. It is a way of financing your company by raising share capital but it has a cash effect. Cash comes into the company when we sell shares to an investor;
- Borrowing money - by obtaining loans and mortgages or issuing bonds;
- Repayment of debts - It should be noted that while paying back principal on loans is a financing activity, payment of interest on loans is an operating activity captured as income expense in the income statement.
- Paying Dividends - If the business is successful in earning a net income, it may pay dividends. Dividends are distributions to shareholders of assets (usually cash) generated by the net income. Dividends are not expenses because the decision of whether or not to distribute them is made after expenses and revenues are recorded.

A typical format would look like this:

Financing Activities

Proceeds from issuance of common stock	XX
Proceeds from issuance of long-term debt	XX
Payment of long term debt	(XX)
Payment of dividends	(XX)
Net cash inflow from financing activities	XXX

Previous Contents Next

Example of Financing Activities as listed in a Cash Flow Statement

Statement of Changes in Financial Position
TME Corporation
For the Year Ended December 31, 1996

	1996
Operating Activities	**$9,000**
Investing Activities	
Proceeds from sale of equipment	$8,000
Purchases of equipment	($25,000)
Increase/(Decrease) in cash	**($17,000)**
Financing Activities	
Proceeds from sales of shares	$20,000
Debt principal payments	($2,000)
Increase/(Decrease) in cash from Financing Activities	**$18,000**

This section of the Statement of Change in Financial Position indicates where we raise share capital or buy shares back from investors, where we borrow money or pay principal back or we pay dividends. In this statement it is shown that during the period the company sold shares and raised share capital of $20,000. From the liabilities and equities portion of the balance sheet we would find that share capital was $100,000 and increased to $120,000 during the period - indicating an increase of $20,000. Since shareholders equity increased due to share capital, cash has to increase.

Another thing that is shown here is that borrowing activities resulted in a net principal reduction of $2,000. Thus, in the financing area there was net cash proceeds of $18,000.

*Click on the play button to hear the audio
Audio Transcript

Previous Contents Next

Net Cash Flow

Totalling the three categories of activities that affected the cash flow in our example, we get:

• a surplus cash flow from operating activities of $9,000,	$9,000
• a negative cash flow from investing activities of $17,000, and	($17,000)
• a positive cash flow of $18,000 from financing activities.	$18,000
Net Cash Inflow	**$10,000**

In this statement, we have isolated out cash and picked up all of the other changes that took place in the other financial statements - some from the other asset accounts and all of the liabilities and equity accounts of the balance sheet, and some from the income statement. The net result was that we had a net cash flow for the period of plus $10,000. More money went into the company then went out by $10,000.

*Click on the play button to hear the audio

Audio Transcript

Previous Contents Next

Audio Transcript

Now we know we have a net inflow and now we can look at the sources and uses of cash. What were our sources from cash? Profit from operations contributed $9,000, sales of equipment contributed $8,000, proceeds from sales of shares contributed $20,000. What were the uses of cash? We bought new equipment for $25,000, and we paid down some debt by $2,000.

Not much happened during this year, but you can extract three important piece of information, I know that the company had a gain in cash, I know where it is coming from and I know what they used it for. This is important information if you are a manager, lender or investor. You do not see this information on the income statement because it does not provide cash flow.

Statement of Changes in Financial Position - Summary

The Statement of Changes in Financial Position is often referred to as the Cash Flow statement. It provides information about the operating, financing, and investing activities of the company and the effects of those activities on the cash position of the company.

> *In the Statement of Changes in Financial Position (Cash Flow Statement), increases and decreases during the accounting period in liabilities, shareholder's equity and other assets, are calculated to determine the increase or decrease in cash during the same period.*

Cash and the Accounting Equation:

Assets = Liabilities + Shareholder's Equity and

Assets = Cash + Other Assets

Therefore:

Cash + Other Assets = Liabilities + Shareholder's Equity

Cash = Liabilities + Shareholder's Equity - Other Assets

This last equation is used to determine whether the increases or decreases in liabilities, shareholder's equity and other assets will increase or decrease cash:

- Increases in liabilities and shareholder's equity will increase cash
- Decreases in liabilities and shareholder's equity will decrease cash
- Increases in other assets will decrease cash.
- Decreases in other assets will increase cash.

Previous Contents