The ABCs of Financial Performance Measures and Benchmarks for Canada's Tourism Sector

Profiling Your Financial Statements

Guide 2

Discover our true nature

Canadian Tourism Commission
Commission canadienne du tourisme

Canada

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Scott Meis
Executive Director, Research

Preface

The tourism sector has recently experienced a slower growth in sales activities due to the slowdown in economic activities, the September 11, 2001 tragedy, the Iraqi War and most recently the outbreak of Severe Acute Respiratory Syndrome (SARS). Whether this slower growth pace will continue over the next years is still a question mark. However, one thing is certain; to stay competitive and increase profitability, tourism operators will have to be more vigilant in managing their business establishments.

We are pleased to make available *The ABCs of Financial Performance Measures and Benchmarks for Canada's Tourism Sector* Guides. There are six guides in the series:

- Guide 1 – Financial Planning: Key to Maximizing Your Bottom Line
- Guide 2 – Profiling Your Financial Statements
- Guide 3 – Financial Performance Measures and Benchmarks for Canada's Tourism Operators
- Guide 4 – Decision-making Tools for Canada's Tourism Operators
- Guide 5 – Linking Your Financial Performance Measures to Your Business Plan
- Guide 6 – Industry Financial Averages and Benchmarks for Canada's Tourism Operators.

These six financial planning guides were written for tourism operators who have little or no experience in the area of finance. These guides can be used as reference documents by tourism operators who wish to better understand the language of accounting and finance, maximize the utilization of the financial planning spreadsheet, and discuss with more self-assurance their financial plans with investors. These guides become progressively more sophisticated, ranging from the principles of finance and culminating with cutting edge performance measures and financial analysis and decision-making techniques.

In addition, to help tourism operators in improving the analysis of their business establishment and the effectiveness of their decisions, we will also be introducing a new tool; a customized tourism operators' financial planning spreadsheet in the near future. This practical and user-friendly tool can help tourism operators analyze quickly the impact of their decisions on the financial destiny of their business establishments. After taking just a few moments to input their financial statement data on the spreadsheet, tourism operators will be able to view the financial profile of their businesses from different angles: liquidity, profitability, productivity, overall financial health, growth rate, financial stability and shareholder value. The financial planning spreadsheet will not only calculate the more critical financial performance measures of their business, but will also compare them to industry averages and financial benchmarks. This way, tourism operators will be able to determine how well they are doing and what needs to be done to improve their performance in order to remain profitable and competitive. This spreadsheet also offers tourism operators several decision tools that will help better assess the viability of their investment decisions.

The CTC has made every effort to ensure the accuracy of the information contained in these guides. The CTC does not accept any legal responsibility for consequences that may arise from errors, omissions or any opinions given. These guides are not a substitute for specific professional advice on business or other matters.

These six guides and the financial planning spreadsheets will be made available on the CTC's website: www.canadatourism.com

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Introduction

The first guide in this series, *Financial Planning: Key to Maximizing Your Bottom Line*, described why tourism operators should analyze their financial statements and explained the importance of financial planning – a crucial managerial function. This guide examines *financial statements* – the documents used to analyze financial performance and capital structure. Financial statements include income statements, statements of retained earnings, balance sheets and statements of cash flows. These are all published in a company's annual report.

The illustration below shows the profile and basic contents of these four financial statements.

- First, a tourism establishment's *financial performance* is presented in a report called the income statement, also known as statement of operations, profit and loss statement, or statement of earnings.
- Second, the *financial structure* of a business is described in another report called the balance sheet, also referred to as the statement of financial condition or statement of financial position.
- Third, the *statement of retained earnings* shows the amount of earnings that the shareholders decided to re-invest in the business since it started and the amount of dividends paid to them during the current year.
- Fourth, the *statement of cash flows*, also known as the statement of changes in financial position, shows the amount of cash that was obtained from the business (e.g., profit) and from external sources (e.g., investors) and the amount that was invested to purchase capital assets.

The *income statement* is much like a movie; it runs during a specific operating period (say from January 1 to December 31). This is the reason why the income statement includes a phrase such as "for the period ended December 31." The *balance sheet*, on the other hand, is akin to a snapshot of a firm's financial position at a given point in time (say December 31). For this reason, the balance sheet typically includes a phrase such as "as at December 31." The *statement of cash flows* shows the amount of cash that was received or disbursed between two consecutive balance sheets.

A fun parallel can be drawn between the growth of a person (as measured in weight) and the growth of a business (as measured in wealth). Suppose that both John Pound and ABC Inc. came into being in 1960, and that annual growth records were kept for each. At the end of the first year, John weighed 20 pounds; and ABC Inc. accumulated $100,000 in income after taxes. During the next 40 years, John's daily activities included eating (intake of food and drinks) and exercising (burning of calories); ABC Inc. collected sales revenue and incurred expenses.

Every year, John produced a home movie depicting his growth; ABC produced an income statement. Also, at the end of each year, John weighed himself to determine how much he had gained or lost, and recorded the results in his diary. ABC's accumulated gains were recorded in its balance sheet. The number of pounds John gained (or lost) each year was added to (or subtracted from) the previous year's figure. ABC's profits (or losses) were also added to (or subtracted from) the previous year's balance sheet – in the retained earnings account.

Let's now assume that John weighed 170 pounds on January 1, 2002 and 180 pounds on December 31, 2002 – an increase of 10 pounds. During the year however, his weight actually rose by 15 pounds before a strict diet helped him shed five pounds. The removal of excess weight is comparable to the payment of dividends to ABC shareholders – as recorded in the company's statement of retained earnings. ABC Inc.'s earnings and dividends are also recorded on three financial statements.

This information would be recorded as follows:

	John Pound	ABC Inc.
Beginning of year (January 1, 2002)		
On the scale	170 pounds	
Last year's balance sheet		$1,000,000
Change during the year		
Changes in calories	+ 15 pounds	
Income statement (income)		+$200,000
Adjustment during the year		
Removal of excess fat	- 5 pounds	
Net change	+ 10 pounds	
Statement of retained earnings (dividends)		-$100,000
Statement of retained earnings (net change)		+$100,000
End of year (December 31, 2002)		
On the scale	180 pounds	
This year's balance sheet		$1,100,000

To help explain these four financial statements in more detail, let's consider the case of a fictional company: TravelWorld Inc. Appendices 2.1, 2.2, 2.3, and 2.4 present, respectively, TravelWorld's income statement, statement of retained earnings, balance sheet, and statement of cash flows.

The Income Statement

As mentioned earlier, the income statement is much like a movie of a business establishment. It shows the flow of revenues and expenses during a given period (e.g., one month, that is from say June 1 to June 30, or one year, say from January 1 to December 31). As shown in Appendix 2.1, the income statement shows income (shaded) at four levels:

- The first level is the *gross margin*, which is calculated by deducting the cost of producing the goods sold (or providing services) from sales revenue.
- The second level is the *operating income*, which is calculated by deducting operating expenses such as selling and administrative expenses from the gross margin.
- The third level, *income before taxes*, is computed by adding other income to the operating income, and by deducting other charges from this balance.
- The fourth level is the *income after taxes*. It is often referred to as the owners' section, since income after taxes actually belongs to the shareholders, to be paid in dividends or to be retained in the business for reinvestment or debt reduction.

Typically, everyone associated with a firm wants to know if it is profitable and how much profit it generates. TravelWorld's income statement (Appendix 2.1) is read in a step-down fashion and presents four levels of profitability in three distinct sections:

1. the *operating section*, which shows both the gross margin and the operating income;
2. the *non-operating section*, which shows income before taxes; and
3. the *owners' section*, which shows income after taxes, that is the amount left to the owners.

Operating Section*

Gross margin

The gross margin (also referred to as gross profit) is calculated by subtracting the cost of goods sold from net sales revenue.

Net sales revenue	$25,082
Less cost of goods sold	$13,017
Gross margin	$12,065

Net sales revenue or sales revenue is what a business earns from the sale of its products and services delivered or shipped to customers during the fiscal period. The term net sales (or net sales revenue) is used because the figure includes adjustments for discounts and returns. Sales taxes (provincial and GST) are not included in net sales revenue. Net sales revenue is the amount a business receives to cover all operating expenses and to generate a profit.

Cost of goods sold (also known as cost of sales) is the cost incurred in making or producing the goods (or providing the services) that the company sold. It is by far the largest expense in the income statement for a manufacturer (in many cases, it may represent 80 percent of total expenses). It includes three major items: materials purchased from suppliers, transportation costs or freight-in for goods shipped to the company's plant, and all expenses associated with manufacturing, such as wages and depreciation of equipment and machinery. For a retailer, this cost can include the purchase of goods from manufacturers or wholesalers for re-sale purposes; for a service-based business, this cost includes the salaries of employees who deliver services to clients.

Gross margin is the difference between goods sold and net sales revenue. It is the profit a business makes after paying the costs of making the goods or providing the services. It is called gross margin because no other types of expenses have been deducted, and it represents the amount of money left to pay for other expenses, such as selling and administration. Gross margin is the starting point for earning an adequate income after taxes.

Operating income

Operating income – sometimes called operating earnings or earnings before interests and taxes (EBIT) – is calculated by deducting operating expenses, such as selling and administrative expenses, from the gross margin. Generally, operating expenses include all expenses other than the cost of goods sold, interest and income tax. There are sometimes hundreds of operating expenses included in this category ranging from salaries (often a large amount) to legal fees (usually a small amount).

S*elling expenses* are costs incurred to promote, sell, and distribute a company's goods and services. These expenses include sales salaries, commissions, advertising, travel, trade shows, sales supplies, delivery expenses, and sales promotions.

Administrative expenses are all other expenses not directly related to the production and sale of goods and services. These include expenses incurred by administrative units such as human resources, accounting, legal and finance as well as the cost of computers, consultants, insurance, and depreciation (a non-cash expense).

*The numbers appearing under the column 2001 will be used to explain the contents of the four financial statements in this Guide. Also, the numbers in this section and in the Appendix are expressed in thousands of dollars.

The purchase of office equipment or computers is considered a capital expenditure, and is subject to depreciation. The cost of this equipment is amortized – spread out over a certain number of years, according to its estimated useful lifespan. A percentage of the initial purchase price is entered under administrative expenses as "depreciation". Assets subject to depreciation might include equipment, computers, tools, machinery and buildings.

By subtracting all operating expenses from the gross margin, we obtain the second level of profit, operating income. Operating income is directly affected by decisions made by operating managers (e.g., cost of goods sold, selling and administrative expenses); therefore, managers are accountable for the operating income performance.

Gross margin	$12,065
Less: total operating expenses	$6,936
Operating income	$5,129

Non-Operating Section

This section deals with income and expenses not directly connected to a firm's principal operating activities.

Income before taxes

Operating income, or income before interest and taxes includes three types of items: (1) interest income and charges, (2) extraordinary items, and (3) nonrecurring items.

- *Interest income* includes interest earned on investments, such as short-term deposits; interest charges include interest paid for borrowed funds.
- *Extraordinary items* are unusual and infrequent gains (revenue) or losses (expenses) for a given year. Unrelated to the usual activities of a business, they are not expected to occur again (e.g. loss from a fire).
- *Nonrecurring items* are also unusual or infrequent. A firm might sell a major capital asset, for example, and record a gain. Or a business might incur a restructuring charge when it provides laid-off employees with severance packages. These unusual gains or losses are reported separately from regular operations, since they would unduly complicate the analysis and forecasting of financial performance.

Operating income		$ 5,129
Plus: interest income	$11	
Less: interest charges	950	
Less: extraordinary expenses	10	949
Income before taxes		$ 4,180

In this example the company's expenses exceed income by $949,000 reducing operating profit to $4,180,000. This amount, called income before taxes, is used for three purposes: to pay income taxes, to pay dividends to shareholders, and to reinvest in the business.

Owners' Section

This section deals with the amount of money left for shareholders – the bottom line.

Income after taxes

Income after taxes is the amount of money or profit that belongs to shareholders.

Income taxes

This is the total amount of taxes due to federal and provincial governments on taxable income earned during the current fiscal period. It is calculated by multiplying taxable income by the appropriate tax rate (in this case, 34 percent). The income-tax expense does not include other taxes, such as payroll and property taxes, which are included in cost of goods sold and operating expenses.

Income before taxes	$4,180
Less: income taxes	1,420
Income after taxes	$2,760

As shown in Appendix 2.1, TravelWorld Inc. earned $2,760,000 in income after taxes during the year 2001. It is the responsibility of the board of directors to decide how much of this amount will be paid in shareholder dividends and how much will be left in the business in the form of retained earnings. The portion of the income after taxes paid to shareholders and retained in the business appears on the next statement, called the statement of retained earnings.

The Statement of Retained Earnings

The statement of retained earnings shows the amount of income retained since the business was created. The statement also identifies income earned and dividends paid during the current operating year, and the amount of earnings remaining in the business at the end of the period.

The statement of retained earnings – relatively simple to prepare – is an important statement because it links the income statement with the balance sheet. As shown in Appendix 2.2, this statement shows:

1. the amount of accumulated earnings at the start of the period (i.e., money not distributed to shareholders); this amount should agree with the retained earnings listed on the balance sheet for the previous year;
2. the total net income (or loss) after taxes for the current operating year, drawn from the current year's income statement;
3. any amounts paid in shareholder dividends; and
4. the amount of retained earnings at the end of the period – this amount determines the retained earnings figure to appear in the balance sheet for the current year.

TravelWorld Inc.'s statement of retained earnings shows that the business establishment had an amount of $10,667,000 at the beginning of year 2001. It should be noted that the net earnings of $2,760,000 for the year 2001 was obtained from the income statement, and the $13,277,000 retained earnings as at December 31, 2001 (after paying $150,000 in dividends) is the same as the amount shown on the balance sheet (see Appendix 2.3).

The Balance Sheet

The balance sheet is considered a snapshot of a company's financial position or financial condition. It is usually divided into six sections (see Appendix 2.3). The upper portion shows what a business establishment owns, or its assets. Asset accounts are divided into three groups:

- *Current assets* are accounts that are more liquid or can be converted into cash quickly, such as accounts receivable, inventory, marketable securities, and prepaid expenses.
- *Capital assets*, also referred to as fixed assets, include illiquid accounts such as land, buildings, machinery and equipment. Typically these assets are used by a business over an extended period of time.
- *Intangible assets*, such as goodwill and patents, are also listed as assets on the balance sheet.

The lower portion shows what a business owes to its creditors (lenders) and shareholders (owners). Debts are divided into two groups:

- *Current liabilities* are loans due within a twelve-month period, such as accounts payable, term loans and accrued expenses.
- *Long-term debts* include loans to be repaid beyond the current accounting period, such as long-term loans, bonds and mortgages.

The lower portion of the balance sheet also shows the equity account, which lists funds provided by shareholders.

Appendix 2.3 presents TravelWord Inc.'s balance sheet – a position statement of the company as at December 31, 2001. Each separate item recorded on the balance sheet is called an account. Each account has a name and a dollar amount, listed in the balance sheet at the end of the accounting period. A balance sheet is like a snapshot in that it gives a picture of each major account at a particular moment in time; it does not reveal how individual accounts changed during the year. Interpreted correctly, a balance sheet can reveal much about the health of a business at the close of an accounting period.

Let's begin by discussing the meaning and significance of major accounts. A balance sheet lists assets, liabilities, and shareholders' equity (also known as net worth). As shown on TravelWorld Inc.'s balance sheet for the year 2001, the total of all assets ($27,297,000), equals the liability and equity side of the balance sheet. Let's now examine the meaning of the balance sheet's six sub-accounts: current assets, capital assets, intangible assets, current liabilities, long-term debts and shareholder equity.

Assets

Assets are the physical items (tangible) and rights (intangible) owned by a business. Assets have a monetary value and are usually divided into two groups: current assets and capital assets. Some businesses with other assets, such as investments and intangible assets, will show them separately.

Current assets

Current assets are defined as cash and other assets expected to be converted into cash during the operating cycle (usually in one year or less). They include cash, marketable securities, accounts receivable, notes receivable, inventories and prepaid expenses. It is common to list these assets on the balance sheet in order of liquidity. Cash – more liquid than marketable securities – will be listed first, for instance. Similarly, notes receivable are typically listed before inventory.

Cash includes all funds on hand or in an accessible bank account, such as bills, coins, and cheques. A certain reservoir of cash is usually kept on hand to pay current bills and to take advantage of specific opportunities, such as cash discounts.

Marketable securities include items that can be readily converted into cash (in less than one year), such as term deposits or shares; they are often regarded as an added reservoir of cash. Since these assets typically yield higher returns than bank accounts, many companies often buy securities.

Prepaid expenses are payments made for services not yet received, such as rent, insurance, office supplies and property taxes. These operating expenses are recorded before services are received. For example, TravelWorld Inc. might pay an insurance premium of $8,000 on June 30 for a one-year policy. Since TravelWorld Inc.'s accounting cycle closes on December 31, half of the premium, $4,000, is registered as a prepaid expense. Should TravelWorld Inc. decide to cancel its policy on December 31, the insurance company will owe TravelWorld Inc. $4,000. This is why such items must be regarded as assets. Other examples include office supplies bought in bulk and used up over several months, and property taxes paid at the start of a taxation year. These amounts should be allocated to the time periods when the goods or services are used.

Accounts receivable represents money owed to the company by its regular customers for the purchase of goods or services, to be collected within a reasonable time period (usually 30 to 90 days). Some businesses formulate credit policies and collection procedures to reduce the amount of cash tied up in this account and minimize the time it takes to turn receivables into cash.

Notes receivable are written promises with specific maturity dates. A note receivable might represent a settlement of an invoice by a customer without the cash to pay according to the company's credit terms. When a company believes that an invoice will not be collected, it will open an account called allowance for doubtful receivables. To reflect its true value as a negative asset, it is deducted from the regular accounts receivable.

The *inventory* account describes the monetary value a company places on the material it has purchased or goods it has manufactured. Usually, a manufacturer has three types of accounts under inventory:

- *Raw materials*, which include goods purchased from various suppliers to be used for manufacturing purposes;
- *Work-in-process*, which includes the goods or materials tied up in various stages of production, somewhere between raw materials and finished goods; and
- *Finished goods*, which are products ready for sale.

Since inventory is not a source of income, management makes an effort to keep it at low levels or to move it as fast as possible. Inventory is recorded at cost and not at the price the firm hopes to sell it for.

Capital assets

Capital assets (also called fixed assets) are items that are considered permanent and are to be used over an extended period of time (many years). The time factor is important because it characterizes the principle difference between current and capital assets. Capital assets have either a limited life span (buildings, equipment, machinery) or an unlimited life span (land). In the year that a capital asset is purchased, its purchase price is usually listed on the balance sheet. However, a company may experience significant changes in the value of some assets and will consequently write up, or increase, their value. In other instances, the company will write down an asset, or decrease its value. When this is done, a financial report will use a footnote to explain the difference between original cost and new value. For example, a write-up would take place when the value of a piece of land appreciates significantly, while a write-down would be done when a capital asset becomes obsolete.

Capital assets (other than land) have a finite life span and wear out over a number of years. A company allocates a certain amount of the capital asset's total value over many years; this allocated amount is called depreciation. For example, if a building with an original cost of $600,000 has a 20-year physical life span, $30,000 will be allocated as an expense each year. Although is not a cash outlay, the $30,000 is considered an expense and registered as such in the income statement. If the building has been used for four years, the balance sheet will show an accumulated depreciation of $120,000 deducted from the gross (also called original or purchase price) capital asset. The difference between gross capital assets and the accumulated depreciation is called net capital assets or net book value. Book value can be defined as purchase price minus accumulated depreciation – the sum of all annual depreciation since the purchase of the capital asset.

Intangible Assets

Intangible assets represent the values of trademarks, goodwill, franchises and patents. These items are not tangible but represent some value to the owners of a business. Goodwill, for example, arises when a firm purchases another firm for a price higher than the value of its tangible assets. This difference represents the potential earning power of its name or reputation. Company trademarks such as Coca Cola, McDonald's arch and Microsoft are worth millions of dollars.

Liabilities

Liabilities represent the debts of a business; credit extended by persons or other businesses (other than shareholders) to assist with the purchase of assets. Liabilities are also divided into two distinct groups: current liabilities and long-term debts.

Current Liabilities

Current liabilities are what a business has to pay to its creditors; monies owed within a short time (less than one year). Normally, such debts are incurred to finance current assets. Current liabilities include accounts payable, notes payable, accrued expenses and taxes.

Accounts payable usually represents a firm's most current debts. This is the money owed to suppliers of goods or services purchased on credit.

Notes payable are written promises to repay a specified sum of money within a short period time (less than one year).

Accrued liability accounts (accruals) represent what a company owes for services it has received and not yet paid for or for expenses incurred but not yet recorded. Normally, a business records operating expenses as soon as invoices are received, even though it might not pay the invoices until several weeks later. However, when a business closes its books for the year, certain unpaid expenses must be identified. For instance, if employees are paid every second week and the company closes its books on December 31, it would have to record what it owes (as a liability) in employee salaries for the week prior to December 31. Typical examples of accrued liabilities include:

- accumulated vacation and sick leave pay;
- interest on debt that hasn't come due by year-end;
- property taxes that should be charged for the year, but not yet paid ; and,
- warranty and guarantee work to be done in the following year on products already sold.

Accrued liabilities are the opposite of prepaid expenses. They describe amounts for services received, but not yet paid for and not included in accounts payable.

Long-Term Debts

Long-term debts include accounts that are not due for at least one year. They include items such as mortgages, contracts and long-term notes and loans, such as bonds. These items are used to finance the purchase of capital assets. A mortgage is a long-term obligation against which a company has pledged certain capital assets (land and buildings) in collateral. This assures lenders that the value of some assets will be available to them if the company ceases to operate, or is sold or liquidated. Long-term notes are similar to notes payable (current liabilities), except that long-term notes are repaid beyond a one-year period.

Shareholders' Equity

Shareholders' equity is another way of financing a business. This money comes from the owners of a business in the form of a capital account (if it is a sole proprietorship), partners' account (if it is a partnership), or capital shares (if it is a corporation).

Capital shares represent the amount of money put into a business by shareholders. These could be common shares (certificates of ownership in a company) or preferred shares (shares that rank ahead of common shares in their claims on dividends and in their claim on assets in the event of liquidation).

Retained earnings represent the profits or income after taxes generated by the business and not paid out in dividends. This includes amounts accumulated by and reinvested into a business to finance the purchase of current or capital assets and to pay off debt principal. When a company makes a profit during a given year, the amount in the retained earnings account on the current year's balance sheet will be greater than the amount shown on the previous year's balance sheet. Conversely, when it incurs a loss, the retained earnings account will drop accordingly.

The Statement of Cash Flows

Cash flow can be examined at two levels: micro and macro. At the *micro level*, cash flow looks at short-term operating statements, such as monthly cash receipts and disbursements. The financial tool used to determine cash flow at the micro level is called a *cash budget*, and is one aspect of the treasury function. The objective is to ensure that a company has enough cash on hand to pay regular bills and debts, such as salaries and advertising, when they fall due. When a company accumulates enough cash reserve, the treasurer usually invests the surplus in short-term securities. This type of analysis and decision-making has to do with *liquidity*.

At the *macro level*, cash flow deals with insolvency and the ability of a business to:

1. generate cash from its operations (profit plus depreciation and the management of working-capital accounts);
2. pay all debts and dividends; and
3. purchase capital assets (capital budget).

While the operating cash receipts and disbursements show the liquidity performance of a business, the information dealing with insolvency appears in the statement of cash flows (also called the statement of changes in financial position). That information relates to three different activities: operating, investing and financing.

The statement of cash flows shows where funds came from and where they went between two accounting periods. As shown in Appendix 2.4, this statement is divided into four sections:

- The first, *operating activities*, shows the sources and uses of funds generated by the business itself (e.g., income after taxes, depreciation, etc.).
- The second, *financing activities*, includes items such as long-term loans and shareholders' participation.
- The third, *investing activities*, includes transactions such as the purchase or sale of capital assets.
- The fourth, *cash balance*, shows the effects that all changes (sources or uses of funds) registered under the three activities have had on the cash account.

Preparing a statement of cash flows is a relatively complex task; interpreting it is fairly straightforward and of great importance to stakeholders. To prepare this statement, financial information is drawn from (1) the balance sheet, (2) the income statement, and (3) the statement of retained earnings.

TravelWorld Inc.'s statement of cash flows, presented in Appendix 2.4, lists the sources and uses of funds under three main headings:

- operating activities;
- financing activities;
- investing activities.

Operating Activities

Operating activities deal with the flow of funds generated by the business itself (internally generated funds). There are three important items in this section: income after taxes, depreciation, and net change in non-cash working capital accounts.

Income after taxes and depreciation

TravelWorld Inc. earned $2,760,000 in income after taxes in 2001 (see Appendix 2.1). The company generated $4,820,000 in cash, once $2,060,000 is added for depreciation. The depreciation amount represents the total from three expenses: cost of goods sold ($1,280,000), selling expenses ($250,000), and administrative expenses ($530,000). Depreciation is added back to income after taxes since this account is a book entry and does not represent a cash outflow.

Net Change in Non-Cash Working Capital Accounts

The statement of cash flows does not usually give a detailed listing of the cash flow generated by a company's individual working-capital accounts. However, since working-capital accounts are important elements in cash-flow management, a company often produces a detailed statement called the *net change in non-cash working capital accounts* (see the listing below). This statement shows whether individual working capital accounts are generating cash (a source) or applying funds (a use). Although a company's net increase in working capital may not change dramatically, this does not mean that all accounts are under control. Non-cash working capital accounts include all current assets (excluding cash), and all current liability accounts. These accounts are all drawn from the balance sheet for 2001.

Net change in non-cash working capital accounts		
Sources		
Increase in accounts payable	$150,000	
Increase in notes payable	50,000	
Increase in working capital loan	18,000	
Increase in accruals	9,000	$227,000
Uses		
Increase in marketable securities	$10,000	
Increase in prepaid expenses	5,000	
Increase in accounts receivable	200,000	
Increase in inventory	140,000	355,000
Net increase (decrease) in non-cash		$128,000

Working capital accounts

The eight working capital accounts drawn from TravelWorld Inc.'s balance sheet show a net use of $128,000. This means that the business used $128,000 in the past year to carry on its day-to-day operations. In this case, by adding back depreciation ($2,060,000) to the income after taxes ($2,760,000), the income statement generated $4,820,000 in cash, and the working capital accounts shown on the balance sheet resulted in a $128,000 outflow. As shown in the upper portion of the statement of cash flows under the heading Operating Activities (Appendix 2.4), the total funds generated from the business's operations during 2001 amount to $4,692,000.

Financing Activities

Financing activities deal with the flow of funds registered in the sale of shares, the repayment of long-term debts, the borrowing of long-term debts and the payment of dividends. All this information is drawn from the balance sheet, with the exception of the payment of dividends, which is obtained from the statement of retained earnings. Sources and uses of funds under financing activities deal with big-ticket accounts, that is, those listed on the lower portion of the balance sheet in the sections dealing with long-term debts and shareholder equity. As shown in Appendix 2.4, under Financing Activities, TravelWorld Inc. paid out a total of $1,364,000 during 2001. First, the shareholders contributed $100,000; second, the business reduced its long-term debt by $1,314,000; and third, it paid $150,000 in dividends.

All accounts appearing under operating and financing activities generated a net $3,328,000 amount (+$4,692,000 - $1,364,000) in cash. Now, what did TravelWold Inc. do with this money? The next section answers this question.

Investing Activities

Investing activities deal with the other big-ticket assets shown in the balance sheet (capital assets). This section shows the source or use of funds for buying or selling capital assets. As shown in Appendix 2.4, TravelWorld Inc. invested $3,250,000 in capital assets and $66,000 in intangible assets for a net $3,316,000 investment.

Cash Balance

Operating and financing activities generated $3,328,000 ($4,692,000 less $1,364,000) to buy $3,316,000 worth of capital assets. The net result of all activities is a surplus of $12,000 – an increase in the company's bank account listed in the lower portion of the Statement of cash flows. The company's balance sheets for 2001 and 2000 reveal that the cash account increased from $140,000 to $152,000.

Appendix 2.1

TravelWorld Inc.

Income Statements

Income Statements
in thousands of $

		2000	2001	Objective
Net sales revenue		**22,342**	**25,082**	**27,965**
Cost of goods sold				
	Purchases	5,545	6,730	7,104
	Freight in	123	210	290
	Salaries	4,621	4,765	5,140
	Depreciation	1,020	1,280	1,890
	Other charges	22	32	40
Total cost of goods sold		**11,331**	**13,017**	**14,464**
Gross margin		**11,011**	**12,065**	**13,501**
Selling expenses				
	Sales salaries	3,603	3,904	4,304
	Commissions	123	130	150
	Travelling	37	40	45
	Advertising	34	47	55
	Depreciation	230	250	280
	Other charges	21	25	30
Total selling expenses		**4,048**	**4,396**	**4,864**
Administrative expenses				
	Salaries	1,545	1,850	2,100
	Leasing	123	130	140
	Depreciation	450	530	600
	Other charges	23	30	35
Total administrative expenses		**2,141**	**2,540**	**2,875**
Total operating expenses		**6,189**	**6,936**	**7,739**
Operating income		**4,822**	**5,129**	**5,762**
	Interest income	10	11	15
	Interest charges	1,140	950	900
	Extraordinary expenses	25	10	15
Income before taxes		**3,667**	**4,180**	**4,862**
Income taxes		1,300	1,420	1,700
Income after taxes		**2,367**	**2,760**	**3,162**

Appendix 2.2

TravelWorld Inc.

Statements of Retained Earnings

Statements of Retained Earnings
in thousands of $

	2000	2001	Objective
Retained earnings (beginning of year)	**8,400**	**10,667**	**13,277**
Net earnings for the year	2,367	2,760	3,162
Sub-total	10,767	13,427	16,439
Dividends	100	150	200
Retained earnings (end of year)	**10,667**	**13,277**	**16,239**

Appendix 2.3

TravelWorld Inc.

Balance Sheets

Balance Sheets

in thousands of $

	2000	2001	Objective
Assets			
Current assets			
Cash	140	152	160
Marketable securities	270	280	285
Prepaid expenses	160	165	170
Accounts receivable	1,150	1,350	1,500
Inventory	520	660	970
Total current assets	**2,240**	**2,607**	**3,085**
Capital assets			
Gross capital assets	29,500	32,750	37,500
Accumulated depreciation	6,200	8,260	11,030
Total net capital assets	**23,300**	**24,490**	**26,470**
Intangible assets	134	200	255
Total assets	**25,674**	**27,297**	**29,810**
Liabilities			
Current liabilities			
Accounts payable	750	900	1,200
Notes payable	300	350	400
Working capital loan	102	120	135
Accruals	61	70	86
Total current liabilities	**1,213**	**1,440**	**1,821**
Total long-term debts	**10,294**	**8,980**	**8,050**
Total debts	**11,507**	**10,420**	**9,871**
Shareholders' equity			
Capital shares	3,500	3,600	3,700
Retained earnings	10,667	13,277	16,239
Total shareholders' equity	**14,167**	**16,877**	**19,939**
Total liabilities and shareholders' equity	**25,674**	**27,297**	**29,810**

Appendix 2.4

TravelWorld Inc.

Statements of Cash Flows

Statements of Cash Flows
in thousands of $

	2001	Total	Objective	Total
Operating activities				
Income after taxes	2,760		3,162	
Depreciation	2,060		2,770	
Marketable securities	-10		-5	
Prepaid expenses	-5		-5	
Accounts receivable	-200		-150	
Inventory	-140		-310	
Accounts payable	150		300	
Notes payable	50		50	
Working capital loan	18		15	
Accruals	9		16	
Total operating activities		**4,692**		**5,843**
Financing activities				
Capital shares	100		100	
Total long-term debts	-1,314		-930	
Dividends	-150		-200	
Total financing activities		**-1,364**		**-1,030**
Investing activities				
Gross capital assets	-3,250		-4,750	
Intangible assets	-66		-55	
Total investing activities		**-3,316**		**-4,805**
Change	-12	**-12**	-8	**-8**
Cash - Beginning of year	140		152	
Cash - End of year	152		160	
Total • Net		**0**		**0**

Glossary for This Guide

Accounts payable: A debt, owed by a business, that arises in the normal course of business for purchases made on credit which should be paid within one year's time.

Accounts receivable: A claim against a debtor for merchandise sold or services rendered in exchange for the customer's promise to pay.

Accrual: Continually recurring short-term liabilities such as accrued wages, accrued taxes, and accrued interest.

Amortization: (1) A reduction in a debt or fund by period payments covering interest and part of principal. (2) Prorating the cost of an intangible asset over a specified number of years.

Assets: Resources that a business owns to produce goods and provide services; there are tangible assets, such as cash, inventory, land, and buildings, and intangible assets, such as patents and goodwill.

Balance sheet: A financial statement that shows a "snapshot" of a company's financial conditions (assets, liabilities, and equity).

Capital assets: Balance sheet accounts such as land, buildings, equipment, and machinery.

Cost of goods sold: Cost incurred in making or producing goods that are sold or providing services.

Current assets: Balance sheet accounts such as cash, accounts receivable and inventory.

Current liabilities: Debts that a business must pay within one year (i.e., accounts payable).

Depreciation: Estimated decrease in the value of capital assets due to wear and tear and/or obsolescence.

Earnings: In general, refers to a company's total sales less cost of sales and operating expenses, including interest and income tax.

EBIT: Abbreviation for earnings before interest and taxes.

Equity: The funds provided in a business by its shareholders. On the balance sheet, owners' equity equals total assets minus total liabilities.

Financial statements: Financial reports, which include the income statement, the statement of retained earnings, the balance sheet and the statement of cash flows.

Financial structure: The way a company's assets are financed by the entire right-hand side of the balance sheet (short-term and long-term debt.)

Financing activities: That portion of the statement of cash flows that shows how much cash was provided (or used) from external sources (e.g., sale of shares, borrowing or repaying a mortgage, payment of dividends).

Goodwill: Intangible assets of a firm established by the excess of the price paid for the on-going business over the value of the assets.

Gross margin: Difference between sales revenue and costs of goods sold.

Income after taxes: Difference between operating income and other expenses (i.e., interest charges), including income taxes.

Income statement: Financial statement that shows a summary of revenues and expenses for a specified period of time (also known as statement of earnings or statement of operations).

Intangible assets: Items that are not tangible but represent some value to a business (e.g., trademarks, patents).

Inventory: Merchandise being held for resale or other uses in a business.

Investing activities: That portion of the statement of cash flows that shows how much cash was provided (or used) to buy or sell assets (e.g., purchase or sale of a building).

Liabilities: Debts of a business.

Long-term debts: Amounts owed by a business to creditors for more than one year. This includes bonds and mortgages.

Mortgage: Loan obtained against which specific real property is used as collateral (e.g., building).

Net sales: What a business earns for the sale of its products and/or services.

Net working capital: The difference between current assets and current liabilities.

Non-operating section: Section on the income statement that shows income or expenses that are not directly related with the principal activities of a business (e.g., interest income, extraordinary expenses, non-recurring expenses).

Operating activities: The portion of the statement of cash flows that shows how much cash was provided (or used) from internal sources (e.g., income after taxes, depreciation).

Operating section: Section of the income statement that shows a company's gross margin and operating income.

Operating income: Difference between gross margin and operating expenses.

Owners' equity: The total funds invested in a business by the owners. This represents the total assets of a business, minus total liabilities. Also known as equity capital or net worth.

Owners' section: Section on the income statement that shows the amount of money left to the shareholders (i.e., income after taxes).

Prepaid expense: An asset representing payment for purchases or services not yet received.

Retained earnings: Amount of money kept by a company after paying dividends to its shareholders.

Statement of cash flows: Also known as the statement of changes in financial position; it shows where funds come from and where they went.

Source of funds: Cash that is obtained from different sources (e.g., obtaining a loan, selling an asset).

Statement of retained earnings: Financial statement that shows the amount of income retained in a business since it was started.

Term loan: Loan made to buy capital assets.

Use of funds: Also known as application of funds, it is cash that is disbursed or expended for buying or paying something (e.g., paying a mortgage, buying a car).

Working capital: Total current assets and total current liabilities.

Working capital management: Managing individual current asset and current liability accounts to ensure proper interrelationships among them.