

Chapter 02

Financial Statements and Cash Flow

Multiple Choice Questions

1. The financial statement showing a firm's accounting value on a particular date is the:
 - A. income statement.
 - B. balance sheet.
 - C. statement of cash flows.
 - D. tax reconciliation statement.
 - E. shareholders' equity sheet.

2. A current asset is:
 - A. an item currently owned by the firm.
 - B. an item that the firm expects to own within the next year.
 - C. an item currently owned by the firm that will convert to cash within the next 12 months.
 - D. the amount of cash on hand the firm currently shows on its balance sheet.
 - E. the market value of all items currently owned by the firm.

3. The long-term debts of a firm are liabilities:
 - A. that come due within the next 12 months.
 - B. that do not come due for at least 12 months.
 - C. owed to the firm's suppliers.
 - D. owed to the firm's shareholders.
 - E. the firm expects to incur within the next 12 months.

4. Net working capital is defined as:
- A. total liabilities minus shareholders' equity.
 - B. current liabilities minus shareholders' equity.
 - C. fixed assets minus long-term liabilities.
 - D. total assets minus total liabilities.
 - E. current assets minus current liabilities.
5. A(n) ____ asset is one which can be quickly converted into cash without significant loss in value.
- A. current
 - B. fixed
 - C. intangible
 - D. liquid
 - E. long-term
6. The financial statement summarizing a firm's accounting performance over a period of time is the:
- A. income statement.
 - B. balance sheet.
 - C. statement of cash flows.
 - D. tax reconciliation statement.
 - E. shareholders' equity sheet.
7. Noncash items refer to:
- A. the credit sales of a firm.
 - B. the accounts payable of a firm.
 - C. the costs incurred for the purchase of intangible fixed assets.
 - D. expenses charged against revenues that do not directly affect cash flow.
 - E. all accounts on the balance sheet other than cash on hand.

8. Your ____ tax rate is the amount of tax payable on the next taxable dollar you earn.
- A. deductible
 - B. residual
 - C. total
 - D. average
 - E. marginal
9. Your ____ tax rate is the total taxes you pay divided by your taxable income.
- A. deductible
 - B. residual
 - C. total
 - D. average
 - E. marginal
10. ____ refers to the cash flow that results from the firm's ongoing, normal business activities.
- A. Cash flow from operating activities
 - B. Capital spending
 - C. Net working capital
 - D. Cash flow from assets
 - E. Cash flow to creditors
11. ____ refers to the changes in net capital assets.
- A. Operating cash flow
 - B. Cash flow from investing
 - C. Net working capital
 - D. Cash flow from assets
 - E. Cash flow to creditors

12. ____ refers to the difference between a firm's current assets and its current liabilities.
- A. Operating cash flow
 - B. Capital spending
 - C. Net working capital
 - D. Cash flow from assets
 - E. Cash flow to creditors
13. ____ is calculated by adding back noncash expenses to net income and adjusting for changes in current assets and liabilities.
- A. Operating cash flow
 - B. Capital spending
 - C. Net working capital
 - D. Cash flow from operations
 - E. Cash flow to creditors
14. ____ refers to the firm's interest payments less any net new borrowing.
- A. Operating cash flow
 - B. Capital spending
 - C. Net working capital
 - D. Cash flow from shareholders
 - E. Cash flow to creditors
15. ____ refers to the firm's dividend payments less any net new equity raised.
- A. Operating cash flow
 - B. Capital spending
 - C. Net working capital
 - D. Cash flow from creditors
 - E. Cash flow to stockholders

16. Earnings per share is equal to:

- A. net income divided by the total number of shares outstanding.
- B. net income divided by the par value of the common stock.
- C. gross income multiplied by the par value of the common stock.
- D. operating income divided by the par value of the common stock.
- E. net income divided by total shareholders' equity.

17. Dividends per share is equal to dividends paid:

- A. divided by the par value of common stock.
- B. divided by the total number of shares outstanding.
- C. divided by total shareholders' equity.
- D. multiplied by the par value of the common stock.
- E. multiplied by the total number of shares outstanding.

18. Which of the following are included in current assets?

- I. equipment
- II. Inventory
- III. accounts payable
- IV. cash

- A. II and IV only
- B. I and III only
- C. I, II, and IV only
- D. III and IV only
- E. II, III, and IV only

19. Which of the following are included in current liabilities?

- I. Note payable to a supplier in eighteen months
- II. Debt payable to a mortgage company in nine months
- III. Accounts payable to suppliers
- IV. Loan payable to the bank in fourteen months

- A. I and III only
- B. II and III only
- C. III and IV only
- D. II, III, and IV only
- E. I, II, and III only

20. An increase in total assets:

- A. means that net working capital is also increasing.
- B. requires an investment in fixed assets.
- C. means that shareholders' equity must also increase.
- D. must be offset by an equal increase in liabilities and shareholders' equity.
- E. can only occur when a firm has positive net income.

21. Which one of the following assets is generally the most liquid?

- A. inventory
- B. buildings
- C. accounts receivable
- D. equipment
- E. patents

22. Which one of the following statements concerning liquidity is correct?

- A. If you sold an asset today, it was a liquid asset.
- B. If you can sell an asset next year at a price equal to its actual value, the asset is highly liquid.
- C. Trademarks and patents are highly liquid.
- D. The less liquidity a firm has, the lower the probability the firm will encounter financial difficulties.
- E. Balance sheet accounts are listed in order of decreasing liquidity.

23. Liquidity is:

- A. a measure of the use of debt in a firm's capital structure.
- B. equal to current assets minus current liabilities.
- C. equal to the market value of a firm's total assets minus its current liabilities.
- D. valuable to a firm even though liquid assets tend to be less profitable to own.
- E. generally associated with intangible assets.

24. Which of the following accounts are included in shareholders' equity?

- I. interest paid
- II. retained earnings
- III. capital surplus
- IV. long-term debt

- A. I and II only
- B. II and IV only
- C. I and IV only
- D. II and III only
- E. I and III only

25. Book value:

- A. is equivalent to market value for firms with fixed assets.
- B. is based on historical cost.
- C. generally tends to exceed market value when fixed assets are included.
- D. is more of a financial than an accounting valuation.
- E. is adjusted to market value whenever the market value exceeds the stated book value.

26. When making financial decisions related to assets, you should:

- A. always consider market values.
- B. place more emphasis on book values than on market values.
- C. rely primarily on the value of assets as shown on the balance sheet.
- D. place primary emphasis on historical costs.
- E. only consider market values if they are less than book values.

27. As seen on an income statement:

- A. interest is deducted from income and increases the total taxes incurred.
- B. the tax rate is applied to the earnings before interest and taxes when the firm has both depreciation and interest expenses.
- C. depreciation is shown as an expense but does not affect the taxes payable.
- D. depreciation reduces both the pretax income and the net income.
- E. interest expense is added to earnings before interest and taxes to get pretax income.

28. The earnings per share will:

- A. increase as net income increases.
- B. increase as the number of shares outstanding increase.
- C. decrease as the total revenue of the firm increases.
- D. increase as the tax rate increases.
- E. decrease as the costs decrease.

29. Dividends per share:

- A. increase as the net income increases as long as the number of shares outstanding remains constant.
- B. decrease as the number of shares outstanding decrease, all else constant.
- C. are inversely related to the earnings per share.
- D. are based upon the dividend requirements established by Generally Accepted Accounting Procedures.
- E. are equal to the amount of net income distributed to shareholders divided by the number of shares outstanding.

30. Earnings per share

- A. will increase if net income increases and number of shares remains constant.
- B. will increase if net income decreases and number of shares remains constant.
- C. is number of shares divided by net income.
- D. is the amount of money that goes into retained earnings on a per share basis.
- E. None of these.

31. According to Generally Accepted Accounting Principles, costs are:

- A. recorded as incurred.
- B. recorded when paid.
- C. matched with revenues.
- D. matched with production levels.
- E. expensed as management desires.

32. Depreciation:

- A. is a noncash expense that is recorded on the income statement.
- B. increases the net fixed assets as shown on the balance sheet.
- C. reduces both the net fixed assets and the costs of a firm.
- D. is a non-cash expense which increases the net operating income.
- E. decreases net fixed assets, net income, and operating cash flows.

33. When you are making a financial decision, the most relevant tax rate is the _____ rate.

- A. average
- B. fixed
- C. marginal
- D. total
- E. variable

34. An increase in which one of the following will cause the operating cash flow to increase?

- A. depreciation
- B. changes in the amount of net fixed capital
- C. net working capital
- D. taxes
- E. costs

35. A firm starts its year with a positive net working capital. During the year, the firm acquires more short-term debt than it does short-term assets. This means that:

- A. the ending net working capital will be negative.
- B. both accounts receivable and inventory decreased during the year.
- C. the beginning current assets were less than the beginning current liabilities.
- D. accounts payable increased and inventory decreased during the year.
- E. the ending net working capital can be positive, negative, or equal to zero.

36. The cash flow to creditors includes the cash:

- A. received by the firm when payments are paid to suppliers.
- B. outflow of the firm when new debt is acquired.
- C. outflow when interest is paid on outstanding debt.
- D. inflow when accounts payable decreases.
- E. received when long-term debt is paid off.

37. Cash flow to stockholders must be positive when:

- A. the dividends paid exceed the net new equity raised.
- B. the net sale of common stock exceeds the amount of dividends paid.
- C. no income is distributed but new shares of stock are sold.
- D. both the cash flow to assets and the cash flow to creditors are negative.
- E. both the cash flow to assets and the cash flow to creditors are positive.

38. Which equality is the basis for the balance sheet?

- A. $\text{Fixed Assets} = \text{Stockholder's Equity} + \text{Current Assets}$
- B. $\text{Assets} = \text{Liabilities} + \text{Stockholder's Equity}$
- C. $\text{Assets} = \text{Current Long-Term Debt} + \text{Retained Earnings}$
- D. $\text{Fixed Assets} = \text{Liabilities} + \text{Stockholder's Equity}$
- E. None of these

39. Assets are listed on the balance sheet in order of:

- A. decreasing liquidity.
- B. decreasing size.
- C. increasing size.
- D. relative life.
- E. None of these.

40. Debt is a contractual obligation that:

- A. requires the payout of residual flows to the holders of these instruments.
- B. requires a repayment of a stated amount and interest over the period.
- C. allows the bondholders to sue the firm if it defaults.
- D. Both requires the payout of residual flows to the holders of these instruments; and requires a repayment of a stated amount and interest over the period.
- E. Both requires a repayment of a stated amount and interest over the period; and allows the bondholders to sue the firm if it defaults.

41. The carrying value or book value of assets:

- A. is determined under GAAP and is based on the cost of the asset.
- B. represents the true market value according to GAAP.
- C. is always the best measure of the company's value to an investor.
- D. is always higher than the replacement cost of the assets.
- E. None of these.

42. Under GAAP, a firm's assets are reported at:

- A. market value.
- B. liquidation value.
- C. intrinsic value.
- D. cost.
- E. None of these.

43. Which of the following statements concerning the income statement is true?
- A. It measures performance over a specific period of time.
 - B. It determines after-tax income of the firm.
 - C. It includes deferred taxes.
 - D. It treats interest as an expense.
 - E. All of these.
44. According to generally accepted accounting principles (GAAP), revenue is recognized as income when:
- A. a contract is signed to perform a service or deliver a good.
 - B. the transaction is complete and the goods or services are delivered.
 - C. payment is requested.
 - D. income taxes are paid.
 - E. All of these.
45. Which of the following is not included in the computation of operating cash flow?
- A. Earnings before interest and taxes
 - B. Interest paid
 - C. Depreciation
 - D. Current taxes
 - E. All of these are included
46. Net capital spending is equal to:
- A. net additions to net working capital.
 - B. the net change in fixed assets.
 - C. net income plus depreciation.
 - D. total cash flow to stockholders less interest and dividends paid.
 - E. the change in total assets.

47. Cash flow to stockholders is defined as:

- A. interest payments.
- B. repurchases of equity less cash dividends paid plus new equity sold.
- C. cash flow from financing less cash flow to creditors.
- D. cash dividends plus repurchases of equity minus new equity financing.
- E. None of these.

48. Free cash flow is:

- A. without cost to the firm.
- B. net income plus taxes.
- C. an increase in net working capital.
- D. cash that the firm is free to distribute to creditors and stockholders.
- E. None of these.

49. The cash flow of the firm must be equal to:

- A. cash flow to stockholders minus cash flow to debtholders.
- B. cash flow to debtholders minus cash flow to stockholders.
- C. cash flow to governments plus cash flow to stockholders.
- D. cash flow to stockholders plus cash flow to debtholders.
- E. None of these.

50. Which of the following are all components of the statement of cash flows?
- A. Cash flow from operating activities, cash flow from investing activities, and cash flow from financing activities
 - B. Cash flow from operating activities, cash flow from investing activities, and cash flow from divesting activities
 - C. Cash flow from internal activities, cash flow from external activities, and cash flow from financing activities
 - D. Cash flow from brokering activities, cash flow from profitable activities, and cash flow from non-profitable activities
 - E. None of these.
51. One of the reasons why cash flow analysis is popular is because:
- A. cash flows are more subjective than net income.
 - B. cash flows are hard to understand.
 - C. it is easy to manipulate, or spin the cash flows.
 - D. it is difficult to manipulate, or spin the cash flows.
 - E. None of these.
52. A firm has \$450 in inventory, \$700 in fixed assets, \$210 in accounts receivable, \$50 in accounts payable, and \$60 in cash. What is the amount of the current assets?
- A. \$510
 - B. \$560
 - C. \$600
 - D. \$660
 - E. \$720

53. Total assets are \$1000, fixed assets are \$700, long-term debt is \$250, and short-term debt is \$300. What is the amount of net working capital?
- A. \$0
 - B. \$50
 - C. \$300
 - D. \$650
 - E. \$700
54. Brad's Company has equipment with a book value of \$500 that could be sold today at a 50% discount. Its inventory is valued at \$450 and could be sold to a competitor for that amount. The firm has \$100 in cash and customers owe it \$250. What is the accounting value of its liquid assets?
- A. \$100
 - B. \$550
 - C. \$800
 - D. \$1,050
 - E. \$1,300
55. Martha's Enterprises spent \$2,500 to purchase equipment three years ago. This equipment is currently valued at \$2,000 on today's balance sheet but could actually be sold for \$2,200. Net working capital is \$300 and long-term debt is \$900. Assuming the equipment is the firm's only fixed asset, what is the book value of shareholders' equity?
- A. \$1,100
 - B. \$1,400
 - C. \$1,600
 - D. \$1,900
 - E. The answer cannot be determined from the information provided

56. Mart's Boutique has sales of \$670,000 and costs of \$460,000. Interest expense is \$50,000 and depreciation is \$55,000. The tax rate is 34%. What is the net income?

- A. \$35,700
- B. \$69,300
- C. \$105,000
- D. \$138,600
- E. \$210,000

57. Given the tax rates as shown, what is the average tax rate for a firm with taxable income of \$126,500?

<u>Taxable Income</u>	<u>Tax Rate</u>
\$0 - 50,000	15%
50,001 - 75,000	25%
75,001 - 100,000	34%
100,001 - 335,000	39%

- A. 21.38%
- B. 23.88%
- C. 25.76%
- D. 34.64%
- E. 39.00%

58. The tax rates are as shown. Your firm currently has taxable income of \$79,400. How much additional tax will you owe if you increase your taxable income by \$21,000?

Taxable Income	Tax Rate
\$ 0 - 50,000	15%
50,001 - 75,000	25%
75,001 - 100,000	34%
100,001 - 335,000	39%

- A. \$7,004
B. \$7,014
C. \$7,140
D. \$7,160
E. \$7,174
59. Your firm has net income of \$198 on total sales of \$1,200. Costs are \$715 and depreciation is \$145. The tax rate is 34%. The firm does not have interest expenses. What is the operating cash flow?
- A. \$93
B. \$241
C. \$340
D. \$383
E. \$485
60. Awnings Incorporated has beginning net fixed assets of \$560 and ending net fixed assets of \$720. Assets valued at \$210 were sold during the year. Depreciation was \$50. What is the amount of capital spending?
- A. \$110
B. \$160
C. \$210
D. \$300
E. \$420

61. At the beginning of the year, a firm has current assets of \$420 and current liabilities of \$380. At the end of the year, the current assets are \$500 and the current liabilities are \$410. What is the change in net working capital?
- A. -\$80
 - B. -\$50
 - C. \$0
 - D. \$50
 - E. \$80
62. At the beginning of the year, long-term debt of a firm is \$310 and total debt is \$350. At the end of the year, long-term debt is \$280 and total debt is \$370. The interest paid is \$50. What is the amount of the cash flow to creditors?
- A. -\$30
 - B. \$0
 - C. \$20
 - D. \$30
 - E. \$80
63. Pete's Boats has beginning long-term debt of \$180 and ending long-term debt of \$210. The beginning and ending total debt balances are \$340 and \$360, respectively. The interest paid is \$20. What is the amount of the cash flow to creditors?
- A. -\$10
 - B. \$0
 - C. \$10
 - D. \$40
 - E. \$50

64. Peggy Grey's Cookies has net income of \$360. The firm pays out 40% of the net income to its shareholders as dividends. During the year, the company sold \$80 worth of common stock. What is the cash flow to stockholders?
- A. \$64
 - B. \$136
 - C. \$144
 - D. \$224
 - E. \$296
65. Thompson's Jet Skis has operating cash flow of \$218. Depreciation is \$45 and interest paid is \$35. A net total of \$69 was paid on long-term debt. The firm spent \$180 on fixed assets and increased net working capital by \$38. What is the amount of the cash flow to stockholders?
- A. -\$104
 - B. -\$28
 - C. \$28
 - D. \$114
 - E. \$142

66.

Nabors, Inc.
2011 Income Statement
(\$ in millions)

Net sales	\$9,610
Less: Cost of goods sold	6,310
Less: Depreciation	<u>1,370</u>
Earnings before interest and taxes	1,930
Less: Interest paid	<u>630</u>
Taxable Income	\$1,300
Less: Taxes	<u>455</u>
Net income	<u>\$ 845</u>

Nabors, Inc.
2010 and 2011 Balance Sheets
(\$ in millions)

	<u>2010</u>	<u>2011</u>		<u>2010</u>	<u>2011</u>
Cash	\$ 310	\$ 405	Accounts payable	\$ 2,720	\$ 2,570
Accounts rec.	2,640	3,055	Notes payable	<u>100</u>	<u>0</u>
Inventory	<u>3,275</u>	<u>3,850</u>	Total	<u>\$ 2,820</u>	<u>\$ 2,570</u>
Total	<u>\$ 6,225</u>	<u>\$ 7,310</u>	Long-term debt	7,875	8,100
Net fixed assets	<u>10,960</u>	<u>10,670</u>	Common stock	5,000	5,250
			Retained earnings	<u>1,490</u>	<u>2,060</u>
Total assets	<u>\$17,185</u>	<u>\$17,980</u>	Total liab.& equity	<u>\$17,185</u>	<u>\$17,980</u>

What is the change in the net working capital from 2010 to 2011?

- A. \$1,235
- B. \$1,035
- C. \$1,335
- D. \$3,405
- E. \$4,740

67.

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What is the amount of the non-cash expenses for 2011?

- A. \$570
- B. \$630
- C. \$845
- D. \$1,370
- E. \$2,000

68.

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What is the amount of the net capital spending for 2011?

- A. -\$290
- B. \$795
- C. \$1,080
- D. \$1,660
- E. \$2,165

69.

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What is the operating cash flow for 2011?

- A. \$845
- B. \$1,930
- C. \$2,215
- D. \$2,845
- E. \$3,060

70.

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What is the cash flow of the firm for 2011?

- A. \$430
- B. \$485
- C. \$1,340
- D. \$2,590
- E. \$3,100

71.

**Nabors, Inc.
2011 Income Statement
(\$ in millions)**

Net sales	\$9,610
Less: Cost of goods sold	6,310
Less: Depreciation	<u>1,370</u>
Earnings before interest and taxes	1,930
Less: Interest paid	<u>630</u>
Taxable Income	\$1,300
Less: Taxes	<u>455</u>
Net income	<u>\$ 845</u>

**Nabors, Inc.
2010 and 2011 Balance Sheets
(\$ in millions)**

	<u>2010</u>	<u>2011</u>		<u>2010</u>	<u>2011</u>
Cash	\$ 310	\$ 405	Accounts payable	\$ 2,720	\$ 2,570
Accounts rec.	2,640	3,055	Notes payable	<u>100</u>	<u>0</u>
Inventory	<u>3,275</u>	<u>3,850</u>	Total	<u>\$ 2,820</u>	<u>\$ 2,570</u>
Total	<u>\$ 6,225</u>	<u>\$ 7,310</u>	Long-term debt	7,875	8,100
Net fixed assets	<u>10,960</u>	<u>10,670</u>	Common stock	5,000	5,250
			Retained earnings	<u>1,490</u>	<u>2,060</u>
Total assets	<u>\$17,185</u>	<u>\$17,980</u>	Total liab. & equity	<u>\$17,185</u>	<u>\$17,980</u>

What is the amount of net new borrowing for 2011?

- A. -\$225
- B. -\$25
- C. \$0
- D. \$25
- E. \$225

72.

Nabors, Inc.
2011 Income Statement
(\$ in millions)

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Less: Cost of goods sold	6,310
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What is the cash flow to creditors for 2011?

- A. -\$405
- B. -\$225
- C. \$225
- D. \$405
- E. \$630

73.

Knickerdoodles, Inc.		
	<u>2010</u>	<u>2011</u>
Sales	\$ 740	\$ 785
COGS	430	460
Interest	33	35
Dividends	16	17
Depreciation	250	210
Cash	70	75
Accounts receivables	563	502
Current liabilities	390	405
Inventory	662	640
Long-term debt	340	410
Net fixed assets	1,680	1,413
Common stock	700	235
Tax rate	35%	35%

What is the net working capital for 2011?

- A. \$345
- B. \$405
- C. \$805
- D. \$812
- E. \$1,005

74.

Knickerdoodles, Inc.		
	<u>2010</u>	<u>2011</u>
Sales	\$ 740	\$ 785
COGS	430	460
Interest	33	35
Dividends	16	17
Depreciation	250	210
Cash	70	75
Accounts receivables	563	502
Current liabilities	390	405
Inventory	662	640
Long-term debt	340	410
Net fixed assets	1,680	1,413
Common stock	700	235
Tax rate	35%	35%

What is the change in net working capital from 2010 to 2011?

- A. -\$93
- B. -\$7
- C. \$7
- D. \$85
- E. \$97

75. **Knickerdoodles, Inc.**

	2010	2011
Sales	\$ 740	\$ 785
COGS	430	460
Interest	33	35
Dividends	16	17
Depreciation	250	210
Cash	70	75
Accounts receivables	563	502
Current liabilities	390	405
Inventory	662	640
Long-term debt	340	410
Net fixed assets	1,680	1,413
Common stock	700	235
Tax rate	35%	35%

What is net capital spending for 2011?

- A. -\$250
- B. -\$57
- C. \$0
- D. \$57
- E. \$477

76. **Knickerdoodles, Inc.**

	2010	2011
Sales	\$ 740	\$ 785
COGS	430	460
Interest	33	35
Dividends	16	17
Depreciation	250	210
Cash	70	75
Accounts receivables	563	502
Current liabilities	390	405
Inventory	662	640
Long-term debt	340	410
Net fixed assets	1,680	1,413
Common stock	700	235
Tax rate	35%	35%

What is the operating cash flow for 2011?

- A. \$143
- B. \$297
- C. \$325
- D. \$353
- E. \$367

77. **Knickerdoodles, Inc.**

	2010	2011
Sales	\$ 740	\$ 785
COGS	430	460
Interest	33	35
Dividends	16	17
Depreciation	250	210
Cash	70	75
Accounts receivables	563	502
Current liabilities	390	405
Inventory	662	640
Long-term debt	340	410
Net fixed assets	1,680	1,413
Common stock	700	235
Tax rate	35%	35%

What is the cash flow of the firm for 2011?

- A. \$50
- B. \$247
- C. \$297
- D. \$447
- E. \$517

78. **Knickerdoodles, Inc.**

	2010	2011
Sales	\$ 740	\$ 785
COGS	430	460
Interest	33	35
Dividends	16	17
Depreciation	250	210
Cash	70	75
Accounts receivables	563	502
Current liabilities	390	405
Inventory	662	640
Long-term debt	340	410
Net fixed assets	1,680	1,413
Common stock	700	235
Tax rate	35%	35%

What is net new borrowing for 2011?

- A. -\$70
- B. -\$35
- C. \$35
- D. \$70
- E. \$105

79. **Knickerdoodles, Inc.**

	2010	2011
Sales	\$ 740	\$ 785
COGS	430	460
Interest	33	35
Dividends	16	17
Depreciation	250	210
Cash	70	75
Accounts receivables	563	502
Current liabilities	390	405
Inventory	662	640
Long-term debt	340	410
Net fixed assets	1,680	1,413
Common stock	700	235
Tax rate	35%	35%

What is the cash flow to creditors for 2011?

- A. -\$170
- B. -\$35
- C. \$135
- D. \$170
- E. \$205

80. **Knickerdoodles, Inc.**

	<u>2010</u>	<u>2011</u>
Sales	\$ 740	\$ 785
COGS	430	460
Interest	33	35
Dividends	16	17
Depreciation	250	210
Cash	70	75
Accounts receivables	563	502
Current liabilities	390	405
Inventory	662	640
Long-term debt	340	410
Net fixed assets	1,680	1,413
Common stock	700	235
Tax rate	35%	35%

What is the cash flow to stockholders for 2011?

- A. \$408
- B. \$417
- C. \$452
- D. \$482
- E. \$503

81.

	<u>2011</u>
Cost of goods sold	\$3,210
Interest	\$215
Dividends	\$160
Depreciation	\$375
Change in retained earnings	\$360
Tax rate	35%

What is the taxable income for 2011?

- A. \$360
- B. \$520
- C. \$640
- D. \$780
- E. \$800

82.		<u>2011</u>
	Cost of goods sold	\$3,210
	Interest	\$215
	Dividends	\$160
	Depreciation	\$375
	Change in retained earnings	\$360
	Tax rate	35%

What is the operating cash flow for 2011?

- A. \$520
- B. \$800
- C. \$1,015
- D. \$1,110
- E. \$1,390

83.		<u>2011</u>
	Cost of goods sold	\$3,210
	Interest	\$215
	Dividends	\$160
	Depreciation	\$375
	Change in retained earnings	\$360
	Tax rate	35%

What are the sales for 2011?

- A. \$4,225
- B. \$4,385
- C. \$4,600
- D. \$4,815
- E. \$5,000

84. Calculate net income based on the following information. Sales are \$250, cost of goods sold is \$160, depreciation expense is \$35, interest paid is \$20, and the tax rate is 34%.
- A. \$11.90
 - B. \$23.10
 - C. \$35.00
 - D. \$36.30
 - E. \$46.20

Essay Questions

85. What is a liquid asset and why is it necessary for a firm to maintain a reasonable level of liquid assets?
86. Why is interest expense excluded from the operating cash flow calculation?

87. Explain why the income statement is not a good representation of cash flow.
88. Discuss the difference between book values and market values on the balance sheet and explain which is more important to the financial manager and why.
89. Note that in all of our cash flow computations to determine cash flow of the firm, we never include the addition to retained earnings. Why not? Is this an oversight?

90. Note that we added depreciation back to operating cash flow and to additions to fixed assets. Why add it back twice? Isn't this double-counting?
91. Sometimes when businesses are critically delinquent on their tax liabilities, the tax authority comes in and literally seizes the business by chasing all of the employees out of the building and changing the locks. What does this tell you about the importance of taxes relative to our discussion of cash flow? Why might a business owner want to avoid such an occurrence?
92. Interpret, in words, what cash flow of the firm represents by discussing operating cash flow, changes in net working capital, and additions to fixed assets.

93. Why is cash flow management important?

94. What is operating cash flow and how does it differ from the total cash flow to the firm?

Chapter 02 Financial Statements and Cash Flow Answer Key

Multiple Choice Questions

1. The financial statement showing a firm's accounting value on a particular date is the:

- A. income statement.
- B. balance sheet.
- C. statement of cash flows.
- D. tax reconciliation statement.
- E. shareholders' equity sheet.

*AACSB: Analytic
Blooms: Remember
Difficulty level: 1 Easy
Topic: The Balance Sheet*

2. A current asset is:

- A. an item currently owned by the firm.
- B. an item that the firm expects to own within the next year.
- C. an item currently owned by the firm that will convert to cash within the next 12 months.
- D. the amount of cash on hand the firm currently shows on its balance sheet.
- E. the market value of all items currently owned by the firm.

*AACSB: Analytic
Blooms: Remember
Difficulty level: 1 Easy
Topic: The Balance Sheet*

3. The long-term debts of a firm are liabilities:
- A. that come due within the next 12 months.
 - B. that do not come due for at least 12 months.
 - C. owed to the firm's suppliers.
 - D. owed to the firm's shareholders.
 - E. the firm expects to incur within the next 12 months.

AACSB: Analytic
Blooms: Remember
Difficulty level: 1 Easy
Topic: The Balance Sheet

4. Net working capital is defined as:
- A. total liabilities minus shareholders' equity.
 - B. current liabilities minus shareholders' equity.
 - C. fixed assets minus long-term liabilities.
 - D. total assets minus total liabilities.
 - E. current assets minus current liabilities.

AACSB: Analytic
Blooms: Remember
Difficulty level: 1 Easy
Topic: Net Working Capital

5. A(n) ____ asset is one which can be quickly converted into cash without significant loss in value.
- A. current
 - B. fixed
 - C. intangible
 - D. liquid
 - E. long-term

AACSB: Analytic
Blooms: Remember

Difficulty level: 1 Easy
Topic: The Balance Sheet

6. The financial statement summarizing a firm's accounting performance over a period of time is the:

A. income statement.
B. balance sheet.
C. statement of cash flows.
D. tax reconciliation statement.
E. shareholders' equity sheet.

AACSB: Analytic
Blooms: Remember
Difficulty level: 1 Easy
Topic: The Income Statement

7. Noncash items refer to:

A. the credit sales of a firm.
B. the accounts payable of a firm.
C. the costs incurred for the purchase of intangible fixed assets.
D. expenses charged against revenues that do not directly affect cash flow.
E. all accounts on the balance sheet other than cash on hand.

AACSB: Analytic
Blooms: Remember
Difficulty level: 1 Easy
Topic: The Income Statement

8. Your ____ tax rate is the amount of tax payable on the next taxable dollar you earn.

- A. deductible
- B. residual
- C. total
- D. average
- E. marginal

AACSB: Analytic
Blooms: Remember
Difficulty level: 1 Easy
Topic: Taxes

9. Your ____ tax rate is the total taxes you pay divided by your taxable income.

- A. deductible
- B. residual
- C. total
- D. average
- E. marginal

AACSB: Analytic
Blooms: Remember
Difficulty level: 1 Easy
Topic: Taxes

10. ____ refers to the cash flow that results from the firm's ongoing, normal business activities.

- A. Cash flow from operating activities
- B. Capital spending
- C. Net working capital
- D. Cash flow from assets
- E. Cash flow to creditors

AACSB: Analytic
Blooms: Remember

Difficulty level: 2 Medium
Topic: Financial Cash Flow

11. ____ refers to the changes in net capital assets.

- A. Operating cash flow
- B.** Cash flow from investing
- C. Net working capital
- D. Cash flow from assets
- E. Cash flow to creditors

AACSB: Analytic
Blooms: Remember
Difficulty level: 2 Medium
Topic: Financial Cash Flow

12. ____ refers to the difference between a firm's current assets and its current liabilities.

- A. Operating cash flow
- B. Capital spending
- C.** Net working capital
- D. Cash flow from assets
- E. Cash flow to creditors

AACSB: Analytic
Blooms: Remember
Difficulty level: 1 Easy
Topic: Net Working Capital

13. ____ is calculated by adding back noncash expenses to net income and adjusting for changes in current assets and liabilities.

- A. Operating cash flow
- B. Capital spending
- C. Net working capital
- D. Cash flow from operations
- E. Cash flow to creditors

AACSB: Analytic
Blooms: Remember
Difficulty level: 2 Medium
Topic: Financial Cash Flow

14. ____ refers to the firm's interest payments less any net new borrowing.

- A. Operating cash flow
- B. Capital spending
- C. Net working capital
- D. Cash flow from shareholders
- E. Cash flow to creditors

AACSB: Analytic
Blooms: Remember
Difficulty level: 2 Medium
Topic: Financial Cash Flow

15. ____ refers to the firm's dividend payments less any net new equity raised.

- A. Operating cash flow
- B. Capital spending
- C. Net working capital
- D. Cash flow from creditors
- E. Cash flow to stockholders

AACSB: Analytic

Blooms: Remember
Difficulty level: 2 Medium
Topic: Financial Cash Flow

16. Earnings per share is equal to:

- A. net income divided by the total number of shares outstanding.
- B. net income divided by the par value of the common stock.
- C. gross income multiplied by the par value of the common stock.
- D. operating income divided by the par value of the common stock.
- E. net income divided by total shareholders' equity.

AACSB: Analytic
Blooms: Remember
Difficulty level: 2 Medium
Topic: The Income Statement

17. Dividends per share is equal to dividends paid:

- A. divided by the par value of common stock.
- B. divided by the total number of shares outstanding.
- C. divided by total shareholders' equity.
- D. multiplied by the par value of the common stock.
- E. multiplied by the total number of shares outstanding.

AACSB: Analytic
Blooms: Remember
Difficulty level: 2 Medium
Topic: The Income Statement

18. Which of the following are included in current assets?

- I. equipment
- II. Inventory
- III. accounts payable
- IV. cash

- A. II and IV only
- B. I and III only
- C. I, II, and IV only
- D. III and IV only
- E. II, III, and IV only

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: The Balance Sheet

19. Which of the following are included in current liabilities?

- I. Note payable to a supplier in eighteen months
- II. Debt payable to a mortgage company in nine months
- III. Accounts payable to suppliers
- IV. Loan payable to the bank in fourteen months

- A. I and III only
- B. II and III only
- C. III and IV only
- D. II, III, and IV only
- E. I, II, and III only

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: The Balance Sheet

20. An increase in total assets:

- A. means that net working capital is also increasing.
- B. requires an investment in fixed assets.
- C. means that shareholders' equity must also increase.
- D. must be offset by an equal increase in liabilities and shareholders' equity.
- E. can only occur when a firm has positive net income.

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: The Balance Sheet

21. Which one of the following assets is generally the most liquid?

- A. inventory
- B. buildings
- C. accounts receivable
- D. equipment
- E. patents

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: The Balance Sheet

22. Which one of the following statements concerning liquidity is correct?

- A. If you sold an asset today, it was a liquid asset.
- B. If you can sell an asset next year at a price equal to its actual value, the asset is highly liquid.
- C. Trademarks and patents are highly liquid.
- D. The less liquidity a firm has, the lower the probability the firm will encounter financial difficulties.
- E. Balance sheet accounts are listed in order of decreasing liquidity.

AACSB: Analytic

Blooms: Understand
Difficulty level: 2 Medium
Topic: The Balance Sheet

23. Liquidity is:
- A. a measure of the use of debt in a firm's capital structure.
 - B. equal to current assets minus current liabilities.
 - C. equal to the market value of a firm's total assets minus its current liabilities.
 - D. valuable to a firm even though liquid assets tend to be less profitable to own.
 - E. generally associated with intangible assets.

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: The Balance Sheet

24. Which of the following accounts are included in shareholders' equity?
- I. interest paid
 - II. retained earnings
 - III. capital surplus
 - IV. long-term debt
- A. I and II only
 - B. II and IV only
 - C. I and IV only
 - D. II and III only
 - E. I and III only

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: The Balance Sheet

25. Book value:

- A. is equivalent to market value for firms with fixed assets.
- B. is based on historical cost.
- C. generally tends to exceed market value when fixed assets are included.
- D. is more of a financial than an accounting valuation.
- E. is adjusted to market value whenever the market value exceeds the stated book value.

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: The Balance Sheet

26. When making financial decisions related to assets, you should:

- A. always consider market values.
- B. place more emphasis on book values than on market values.
- C. rely primarily on the value of assets as shown on the balance sheet.
- D. place primary emphasis on historical costs.
- E. only consider market values if they are less than book values.

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: The Balance Sheet

27. As seen on an income statement:

- A. interest is deducted from income and increases the total taxes incurred.
- B. the tax rate is applied to the earnings before interest and taxes when the firm has both depreciation and interest expenses.
- C. depreciation is shown as an expense but does not affect the taxes payable.
- D. depreciation reduces both the pretax income and the net income.
- E. interest expense is added to earnings before interest and taxes to get pretax income.

AACSB: Analytic

Blooms: Understand
Difficulty level: 2 Medium
Topic: The Income Statement

28. The earnings per share will:

- A. increase as net income increases.
- B. increase as the number of shares outstanding increase.
- C. decrease as the total revenue of the firm increases.
- D. increase as the tax rate increases.
- E. decrease as the costs decrease.

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: The Income Statement

29. Dividends per share:

- A. increase as the net income increases as long as the number of shares outstanding remains constant.
- B. decrease as the number of shares outstanding decrease, all else constant.
- C. are inversely related to the earnings per share.
- D. are based upon the dividend requirements established by Generally Accepted Accounting Procedures.
- E. are equal to the amount of net income distributed to shareholders divided by the number of shares outstanding.

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: The Income Statement

30. Earnings per share

- A. will increase if net income increases and number of shares remains constant.
- B. will increase if net income decreases and number of shares remains constant.
- C. is number of shares divided by net income.
- D. is the amount of money that goes into retained earnings on a per share basis.
- E. None of these.

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: The Income Statement

31. According to Generally Accepted Accounting Principles, costs are:

- A. recorded as incurred.
- B. recorded when paid.
- C. matched with revenues.
- D. matched with production levels.
- E. expensed as management desires.

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: The Income Statement

32. Depreciation:

- A. is a noncash expense that is recorded on the income statement.
- B. increases the net fixed assets as shown on the balance sheet.
- C. reduces both the net fixed assets and the costs of a firm.
- D. is a non-cash expense which increases the net operating income.
- E. decreases net fixed assets, net income, and operating cash flows.

AACSB: Analytic
Blooms: Understand

Difficulty level: 2 Medium
Topic: The Income Statement

33. When you are making a financial decision, the most relevant tax rate is the _____ rate.

- A. average
- B. fixed
- C. marginal
- D. total
- E. variable

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: Taxes

34. An increase in which one of the following will cause the operating cash flow to increase?

- A. depreciation
- B. changes in the amount of net fixed capital
- C. net working capital
- D. taxes
- E. costs

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: Financial Cash Flow

35. A firm starts its year with a positive net working capital. During the year, the firm acquires more short-term debt than it does short-term assets. This means that:

- A. the ending net working capital will be negative.
- B. both accounts receivable and inventory decreased during the year.
- C. the beginning current assets were less than the beginning current liabilities.
- D. accounts payable increased and inventory decreased during the year.
- E. the ending net working capital can be positive, negative, or equal to zero.

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: Net Working Capital

36. The cash flow to creditors includes the cash:

- A. received by the firm when payments are paid to suppliers.
- B. outflow of the firm when new debt is acquired.
- C. outflow when interest is paid on outstanding debt.
- D. inflow when accounts payable decreases.
- E. received when long-term debt is paid off.

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: Financial Cash Flow

37. Cash flow to stockholders must be positive when:

- A. the dividends paid exceed the net new equity raised.
- B. the net sale of common stock exceeds the amount of dividends paid.
- C. no income is distributed but new shares of stock are sold.
- D. both the cash flow to assets and the cash flow to creditors are negative.
- E. both the cash flow to assets and the cash flow to creditors are positive.

AACSB: Analytic

Blooms: Understand
Difficulty level: 2 Medium
Topic: Financial Cash Flow

38. Which equality is the basis for the balance sheet?

- A. Fixed Assets = Stockholder's Equity + Current Assets
- B. Assets = Liabilities + Stockholder's Equity**
- C. Assets = Current Long-Term Debt + Retained Earnings
- D. Fixed Assets = Liabilities + Stockholder's Equity
- E. None of these

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: The Balance Sheet

39. Assets are listed on the balance sheet in order of:

- A. decreasing liquidity.**
- B. decreasing size.
- C. increasing size.
- D. relative life.
- E. None of these.

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: The Balance Sheet

40. Debt is a contractual obligation that:

- A. requires the payout of residual flows to the holders of these instruments.
- B. requires a repayment of a stated amount and interest over the period.
- C. allows the bondholders to sue the firm if it defaults.
- D. Both requires the payout of residual flows to the holders of these instruments; and requires a repayment of a stated amount and interest over the period.
- E. Both requires a repayment of a stated amount and interest over the period; and allows the bondholders to sue the firm if it defaults.

AACSB: Analytic

Blooms: Understand

Difficulty level: 2 Medium

Topic: The Balance Sheet

41. The carrying value or book value of assets:

- A. is determined under GAAP and is based on the cost of the asset.
- B. represents the true market value according to GAAP.
- C. is always the best measure of the company's value to an investor.
- D. is always higher than the replacement cost of the assets.
- E. None of these.

AACSB: Analytic

Blooms: Understand

Difficulty level: 2 Medium

Topic: The Balance Sheet

42. Under GAAP, a firm's assets are reported at:

- A. market value.
- B. liquidation value.
- C. intrinsic value.
- D. cost.
- E. None of these.

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: The Balance Sheet

43. Which of the following statements concerning the income statement is true?

- A. It measures performance over a specific period of time.
- B. It determines after-tax income of the firm.
- C. It includes deferred taxes.
- D. It treats interest as an expense.
- E. All of these.

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: The Income Statement

44. According to generally accepted accounting principles (GAAP), revenue is recognized as income when:

- A. a contract is signed to perform a service or deliver a good.
- B. the transaction is complete and the goods or services are delivered.
- C. payment is requested.
- D. income taxes are paid.
- E. All of these.

AACSB: Analytic

Blooms: Understand
Difficulty level: 2 Medium
Topic: The Income Statement

45. Which of the following is not included in the computation of operating cash flow?

- A. Earnings before interest and taxes
- B. Interest paid**
- C. Depreciation
- D. Current taxes
- E. All of these are included

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: Financial Cash Flow

46. Net capital spending is equal to:

- A. net additions to net working capital.
- B. the net change in fixed assets.**
- C. net income plus depreciation.
- D. total cash flow to stockholders less interest and dividends paid.
- E. the change in total assets.

AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: Financial Cash Flow

47. Cash flow to stockholders is defined as:

- A. interest payments.
- B. repurchases of equity less cash dividends paid plus new equity sold.
- C. cash flow from financing less cash flow to creditors.
- D. cash dividends plus repurchases of equity minus new equity financing.
- E. None of these.

*AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: Financial Cash Flow*

48. Free cash flow is:

- A. without cost to the firm.
- B. net income plus taxes.
- C. an increase in net working capital.
- D. cash that the firm is free to distribute to creditors and stockholders.
- E. None of these.

*AACSB: Analytic
Blooms: Understand
Difficulty level: 2 Medium
Topic: Financial Cash Flow*

49. The cash flow of the firm must be equal to:

- A. cash flow to stockholders minus cash flow to debtholders.
- B. cash flow to debtholders minus cash flow to stockholders.
- C. cash flow to governments plus cash flow to stockholders.
- D. cash flow to stockholders plus cash flow to debtholders.
- E. None of these.

*AACSB: Analytic
Blooms: Understand*

50. Which of the following are all components of the statement of cash flows?

- A. Cash flow from operating activities, cash flow from investing activities, and cash flow from financing activities
- B. Cash flow from operating activities, cash flow from investing activities, and cash flow from divesting activities
- C. Cash flow from internal activities, cash flow from external activities, and cash flow from financing activities
- D. Cash flow from brokering activities, cash flow from profitable activities, and cash flow from non-profitable activities
- E. None of these.

AACSB: Analytic

Blooms: Understand

Difficulty level: 2 Medium

Topic: The Accounting Statement of Cash Flows

51. One of the reasons why cash flow analysis is popular is because:

- A. cash flows are more subjective than net income.
- B. cash flows are hard to understand.
- C. it is easy to manipulate, or spin the cash flows.
- D. it is difficult to manipulate, or spin the cash flows.
- E. None of these.

AACSB: Analytic

Blooms: Understand

Difficulty level: 2 Medium

Topic: Financial Cash Flow

52. A firm has \$450 in inventory, \$700 in fixed assets, \$210 in accounts receivable, \$50 in accounts payable, and \$60 in cash. What is the amount of the current assets?

A. \$510
B. \$560
C. \$600
D. \$660
E. \$720

$$\text{Current assets} = \$450 + \$210 + \$60 = \$720$$

AACSB: Analytic
Blooms: Apply
Difficulty level: 2 Medium
Topic: The Balance Sheet

53. Total assets are \$1000, fixed assets are \$700, long-term debt is \$250, and short-term debt is \$300. What is the amount of net working capital?

A. \$0
B. \$50
C. \$300
D. \$650
E. \$700

$$\text{Net working capital} = \$1000 - \$700 - \$300 = \$0$$

AACSB: Analytic
Blooms: Apply
Difficulty level: 2 Medium
Topic: Net Working Capital

54. Brad's Company has equipment with a book value of \$500 that could be sold today at a 50% discount. Its inventory is valued at \$450 and could be sold to a competitor for that amount. The firm has \$100 in cash and customers owe it \$250. What is the accounting value of its liquid assets?

A. \$100
B. \$550
C. \$800
D. \$1,050
E. \$1,300

Liquid assets = \$450 + \$100 + \$250 = \$800

AACSB: Analytic
Blooms: Apply
Difficulty level: 2 Medium
Topic: The Balance Sheet

55. Martha's Enterprises spent \$2,500 to purchase equipment three years ago. This equipment is currently valued at \$2,000 on today's balance sheet but could actually be sold for \$2,200. Net working capital is \$300 and long-term debt is \$900. Assuming the equipment is the firm's only fixed asset, what is the book value of shareholders' equity?

A. \$1,100
B. \$1,400
C. \$1,600
D. \$1,900
E. The answer cannot be determined from the information provided

Book value of shareholders' equity = \$2,000 + \$300 - \$900 = \$1,400

AACSB: Analytic
Blooms: Apply
Difficulty level: 2 Medium
Topic: The Balance Sheet

56. Mart's Boutique has sales of \$670,000 and costs of \$460,000. Interest expense is \$50,000 and depreciation is \$55,000. The tax rate is 34%. What is the net income?

- A. \$35,700
- B. \$69,300**
- C. \$105,000
- D. \$138,600
- E. \$210,000

Taxable income = \$670,000 - \$460,000 - \$50,000 - \$55,000 = \$105,000; Tax = .34(\$105,000) = \$35,700; Net income = \$105,000 - \$35,700 = \$69,300

AACSB: Analytic

Blooms: Apply

Difficulty level: 2 Medium

Topic: The Income Statement

57. Given the tax rates as shown, what is the average tax rate for a firm with taxable income of \$126,500?

<u>Taxable Income</u>	<u>Tax Rate</u>
\$0 - 50,000	15%
50,001 - 75,000	25%
75,001 - 100,000	34%
100,001 - 335,000	39%

- A. 21.38%
- B. 23.88%
- C. 25.76%**
- D. 34.64%
- E. 39.00%

Tax = .15(\$50,000) + .25(\$25,000) + .34(\$25,000) + .39(\$126,500 - \$100,000) = \$32,585; Average tax rate = \$32,585 ÷ \$126,500 = .2576 = 25.76%

AACSB: Analytic

58. The tax rates are as shown. Your firm currently has taxable income of \$79,400. How much additional tax will you owe if you increase your taxable income by \$21,000?

Taxable Income	Tax Rate
\$ 0 - 50,000	15%
50,001 - 75,000	25%
75,001 - 100,000	34%
100,001 - 335,000	39%

- A. \$7,004
B. \$7,014
C. \$7,140
D. \$7,160
E. \$7,174

$$\text{Additional tax} = .34(\$100,000 - \$79,400) + .39(\$79,400 + \$21,000 - \$100,000) = \$7,160$$

59. Your firm has net income of \$198 on total sales of \$1,200. Costs are \$715 and depreciation is \$145. The tax rate is 34%. The firm does not have interest expenses. What is the operating cash flow?

A. \$93
B. \$241
C. \$340
D. \$383
E. \$485

Earnings before interest and taxes = $\$1,200 - \$715 - \$145 = \340 ; Tax = $[\$198 \div (1 - .34)] - \$198 = \$102$; Operating cash flow = $\$340 + \$145 - \$102 = \383

AACSB: Analytic
Blooms: Apply
Difficulty level: 2 Medium
Topic: Financial Cash Flow

60. Awnings Incorporated has beginning net fixed assets of \$560 and ending net fixed assets of \$720. Assets valued at \$210 were sold during the year. Depreciation was \$50. What is the amount of capital spending?

A. \$110
B. \$160
C. \$210
D. \$300
E. \$420

Net capital spending = $\$720 - \$560 + \$50 = \210

AACSB: Analytic
Blooms: Apply
Difficulty level: 2 Medium
Topic: Financial Cash Flow

61. At the beginning of the year, a firm has current assets of \$420 and current liabilities of \$380. At the end of the year, the current assets are \$500 and the current liabilities are \$410. What is the change in net working capital?

A. -\$80
B. -\$50
C. \$0
D. \$50
E. \$80

$$\text{Change in net working capital} = (\$500 - \$410) - (\$420 - \$380) = \$50$$

AACSB: Analytic
Blooms: Apply
Difficulty level: 2 Medium
Topic: Net Working Capital

62. At the beginning of the year, long-term debt of a firm is \$310 and total debt is \$350. At the end of the year, long-term debt is \$280 and total debt is \$370. The interest paid is \$50. What is the amount of the cash flow to creditors?

A. -\$30
B. \$0
C. \$20
D. \$30
E. \$80

$$\text{Cash flow to creditors} = \$50 - (\$280 - \$310) = \$80$$

AACSB: Analytic
Blooms: Apply
Difficulty level: 2 Medium
Topic: Financial Cash Flow

63. Pete's Boats has beginning long-term debt of \$180 and ending long-term debt of \$210. The beginning and ending total debt balances are \$340 and \$360, respectively. The interest paid is \$20. What is the amount of the cash flow to creditors?

A. -\$10
B. \$0
C. \$10
D. \$40
E. \$50

$$\text{Cash flow to creditors} = \$20 - (\$210 - \$180) = -\$10$$

AACSB: Analytic
Blooms: Apply
Difficulty level: 2 Medium
Topic: Financial Cash Flow

64. Peggy Grey's Cookies has net income of \$360. The firm pays out 40% of the net income to its shareholders as dividends. During the year, the company sold \$80 worth of common stock. What is the cash flow to stockholders?

A. \$64
B. \$136
C. \$144
D. \$224
E. \$296

$$\text{Cash flow to stockholders} = .40(\$360) - \$80 = \$64$$

AACSB: Analytic
Blooms: Apply
Difficulty level: 2 Medium
Topic: Financial Cash Flow

65. Thompson's Jet Skis has operating cash flow of \$218. Depreciation is \$45 and interest paid is \$35. A net total of \$69 was paid on long-term debt. The firm spent \$180 on fixed assets and increased net working capital by \$38. What is the amount of the cash flow to stockholders?

- A. -\$104
- B. -\$28
- C. \$28
- D. \$114
- E. \$142

Cash flow of the firm = $\$218 - \$38 - \$180 = \0 ; Cash flow to creditors = $\$35 - (-\$69) = \$104$;
Cash flow to stockholders = $\$0 - \$104 = -\$104$

AACSB: Analytic
Blooms: Apply
Difficulty level: 2 Medium
Topic: Financial Cash Flow

66.

Nabors, Inc.
2011 Income Statement
(\$ in millions)

Net sales	\$9,610
Less: Cost of goods sold	6,310
Less: Depreciation	<u>1,370</u>
Earnings before interest and taxes	1,930
Less: Interest paid	<u>630</u>
Taxable Income	\$1,300
Less: Taxes	<u>455</u>
Net income	<u>\$ 845</u>

Nabors, Inc.
2010 and 2011 Balance Sheets
(\$ in millions)

	<u>2010</u>	<u>2011</u>		<u>2010</u>	<u>2011</u>
Cash	\$ 310	\$ 405	Accounts payable	\$ 2,720	\$ 2,570
Accounts rec.	2,640	3,055	Notes payable	<u>100</u>	<u>0</u>
Inventory	<u>3,275</u>	<u>3,850</u>	Total	<u>\$ 2,820</u>	<u>\$ 2,570</u>
Total	<u>\$ 6,225</u>	<u>\$ 7,310</u>	Long-term debt	7,875	8,100
Net fixed assets	<u>10,960</u>	<u>10,670</u>	Common stock	5,000	5,250
			Retained earnings	<u>1,490</u>	<u>2,060</u>
Total assets	<u>\$17,185</u>	<u>\$17,980</u>	Total liab.& equity	<u>\$17,185</u>	<u>\$17,980</u>

What is the change in the net working capital from 2010 to 2011?

- A. \$1,235
- B. \$1,035
- C. \$1,335
- D. \$3,405
- E. \$4,740

$$\text{Change in net working capital} = (\$7,310 - \$2,570) - (\$6,225 - \$2,820) = \$1,335$$

AACSB: Analytic

Blooms: Apply

Difficulty level: 2 Medium

Topic: Net Working Capital

67.

Nabors, Inc.
2011 Income Statement
(\$ in millions)

Net sales	\$9,610
Less: Cost of goods sold	6,310
Less: Depreciation	<u>1,370</u>
Earnings before interest and taxes	1,930
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2010 and 2011 Balance Sheets
(\$ in millions)

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Total assets	<u>\$17,185</u>	<u>\$17,980</u>	Total liab.& equity	<u>\$17,185</u>	<u>\$17,980</u>

What is the amount of the non-cash expenses for 2011?

- A. \$570
- B. \$630
- C. \$845
- D. \$1,370
- E. \$2,000

The non-cash expense is depreciation in the amount of \$1,370.

AACSB: Analytic

Blooms: Apply

Difficulty level: 2 Medium

Topic: The Income Statement

68.

Nabors, Inc.
2011 Income Statement
(\$ in millions)

Net sales	\$9,610
Less: Cost of goods sold	6,310
Less: Depreciation	<u>1,370</u>
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Less: Interest paid	<u>630</u>
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Nabors, Inc.
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(\$ in millions)

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			Retained earnings	<u>1,490</u>	<u>2,060</u>
Total assets	<u>\$17,185</u>	<u>\$17,980</u>	Total liab.& equity	<u>\$17,185</u>	<u>\$17,980</u>

What is the amount of the net capital spending for 2011?

- A. -\$290
- B. \$795
- C. \$1,080
- D. \$1,660
- E. \$2,165

$$\text{Net capital spending} = \$10,670 - \$10,960 + \$1,370 = \$1,080$$

AACSB: Analytic

Blooms: Apply

Difficulty level: 2 Medium

Topic: Financial Cash Flow

69.

Nabors, Inc.
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(\$ in millions)

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Less: Depreciation	<u>1,370</u>
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Nabors, Inc.
2010 and 2011 Balance Sheets
(\$ in millions)

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			Retained earnings	<u>1,490</u>	<u>2,060</u>
Total assets	<u>\$17,185</u>	<u>\$17,980</u>	Total liab.& equity	<u>\$17,185</u>	<u>\$17,980</u>

What is the operating cash flow for 2011?

- A. \$845
- B. \$1,930
- C. \$2,215
- D. \$2,845
- E. \$3,060

Operating cash flow = \$1,930 + \$1,370 - \$455 = \$2,845

AACSB: Analytic

Blooms: Apply

Difficulty level: 2 Medium

Topic: Financial Cash Flow

70.

Nabors, Inc.
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Less: Depreciation	<u>1,370</u>
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Less: Interest paid	<u>630</u>
Taxable Income	\$1,300
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(\$ in millions)

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			Retained earnings	<u>1,490</u>	<u>2,060</u>
Total assets	<u>\$17,185</u>	<u>\$17,980</u>	Total liab.& equity	<u>\$17,185</u>	<u>\$17,980</u>

What is the cash flow of the firm for 2011?

- A.** \$430
- B. \$485
- C. \$1,340
- D. \$2,590
- E. \$3,100

Operating cash flow = $\$1,930 + \$1,370 - \$455 = \$2,845$; Change in net working capital = $(\$7,310 - \$2,570) - (\$6,225 - \$2,820) = \$1,335$; Net capital spending = $\$10,670 - \$10,960 + \$1,370 = \$1,080$; Cash flow of the firm = $\$2,845 - \$1,335 - \$1,080 = \430

AACSB: Analytic
Blooms: Apply
Difficulty level: 2 Medium
Topic: Financial Cash Flow

71.

Nabors, Inc.
2011 Income Statement
(\$ in millions)

Net sales	\$9,610
Less: Cost of goods sold	6,310
Less: Depreciation	<u>1,370</u>
Earnings before interest and taxes	1,930
Less: Interest paid	<u>630</u>
Taxable Income	\$1,300
Less: Taxes	<u>455</u>
Net income	<u>\$ 845</u>

Nabors, Inc.
2010 and 2011 Balance Sheets
(\$ in millions)

	<u>2010</u>	<u>2011</u>		<u>2010</u>	<u>2011</u>
Cash	\$ 310	\$ 405	Accounts payable	\$ 2,720	\$ 2,570
Accounts rec.	2,640	3,055	Notes payable	<u>100</u>	<u>0</u>
Inventory	<u>3,275</u>	<u>3,850</u>	Total	<u>\$ 2,820</u>	<u>\$ 2,570</u>
Total	<u>\$ 6,225</u>	<u>\$ 7,310</u>	Long-term debt	7,875	8,100
Net fixed assets	<u>10,960</u>	<u>10,670</u>	Common stock	5,000	5,250
			Retained earnings	<u>1,490</u>	<u>2,060</u>
Total assets	<u>\$17,185</u>	<u>\$17,980</u>	Total liab.& equity	<u>\$17,185</u>	<u>\$17,980</u>

What is the amount of net new borrowing for 2011?

- A. -\$225
- B. -\$25
- C. \$0
- D. \$25
- E. \$225**

$$\text{Net new borrowing} = \$8,100 - \$7,875 = \$225$$

AACSB: Analytic

Blooms: Apply

Difficulty level: 2 Medium

Topic: Financial Cash Flow

72.

Nabors, Inc.
2011 Income Statement
(\$ in millions)

Net sales	\$9,610
Less: Cost of goods sold	6,310
Less: Depreciation	<u>1,370</u>
Earnings before interest and taxes	1,930
Less: Interest paid	<u>630</u>
Taxable Income	\$1,300
Less: Taxes	<u>455</u>
Net income	<u>\$ 845</u>

Nabors, Inc.
2010 and 2011 Balance Sheets
(\$ in millions)

	<u>2010</u>	<u>2011</u>		<u>2010</u>	<u>2011</u>
Cash	\$ 310	\$ 405	Accounts payable	\$ 2,720	\$ 2,570
Accounts rec.	2,640	3,055	Notes payable	<u>100</u>	<u>0</u>
Inventory	<u>3,275</u>	<u>3,850</u>	Total	<u>\$ 2,820</u>	<u>\$ 2,570</u>
Total	<u>\$ 6,225</u>	<u>\$ 7,310</u>	Long-term debt	7,875	8,100
Net fixed assets	<u>10,960</u>	<u>10,670</u>	Common stock	5,000	5,250
			Retained earnings	<u>1,490</u>	<u>2,060</u>
Total assets	<u>\$17,185</u>	<u>\$17,980</u>	Total liab.& equity	<u>\$17,185</u>	<u>\$17,980</u>

What is the cash flow to creditors for 2011?

- A. -\$405
- B. -\$225
- C. \$225
- D. \$405**
- E. \$630

$$\text{Cash flow to creditors} = \$630 - (\$8,100 - \$7,875) = \$405$$

AACSB: Analytic

Blooms: Apply

Difficulty level: 2 Medium

Topic: Financial Cash Flow

73.

Knickerdoodles, Inc.		
	2010	2011
Sales	\$ 740	\$ 785
COGS	430	460
Interest	33	35
Dividends	16	17
Depreciation	250	210
Cash	70	75
Accounts receivables	563	502
Current liabilities	390	405
Inventory	662	640
Long-term debt	340	410
Net fixed assets	1,680	1,413
Common stock	700	235
Tax rate	35%	35%

What is the net working capital for 2011?

- A. \$345
- B. \$405
- C. \$805
- D. \$812
- E. \$1,005

Net working capital = \$75 + \$502 + \$640 - \$405 = \$812

AACSB: Analytic

Blooms: Apply

Difficulty level: 2 Medium

Topic: Net Working Capital

74.

Knickerdoodles, Inc.		
	2010	2011
Sales	\$ 740	\$ 785
COGS	430	460
Interest	33	35
Dividends	16	17
Depreciation	250	210
Cash	70	75
Accounts receivables	563	502
Current liabilities	390	405
Inventory	662	640
Long-term debt	340	410
Net fixed assets	1,680	1,413
Common stock	700	235
Tax rate	35%	35%

What is the change in net working capital from 2010 to 2011?

- A. -\$93
- B. -\$7
- C. \$7
- D. \$85
- E. \$97

Change in net working capital = (\$75 + \$502 + \$640 - \$405) - (\$70 + \$563 + \$662 - \$390) = - \$93

AACSB: Analytic

Blooms: Apply

Difficulty level: 2 Medium

Topic: Net Working Capital

75.

Knickerdoodles, Inc.		
	2010	2011
Sales	\$ 740	\$ 785
COGS	430	460
Interest	33	35
Dividends	16	17
Depreciation	250	210
Cash	70	75
Accounts receivables	563	502
Current liabilities	390	405
Inventory	662	640
Long-term debt	340	410
Net fixed assets	1,680	1,413
Common stock	700	235
Tax rate	35%	35%

What is net capital spending for 2011?

- A. -\$250
- B. -\$57**
- C. \$0
- D. \$57
- E. \$477

Net capital spending = \$1,413 - \$1,680 + \$210 = -\$57

AACSB: Analytic
Blooms: Apply
Difficulty level: 2 Medium
Topic: Financial Cash Flow

76.

Knickerdoodles, Inc.		
	2010	2011
Sales	\$ 740	\$ 785
COGS	430	460
Interest	33	35
Dividends	16	17
Depreciation	250	210
Cash	70	75
Accounts receivables	563	502
Current liabilities	390	405
Inventory	662	640
Long-term debt	340	410
Net fixed assets	1,680	1,413
Common stock	700	235
Tax rate	35%	35%

What is the operating cash flow for 2011?

- A. \$143
- B. \$297**
- C. \$325
- D. \$353
- E. \$367

Earnings before interest and taxes = $\$785 - \$460 - \$210 = \115 ; Taxable income = $\$115 - \$35 = \$80$; Taxes = $.35(\$80) = \28 ; Operating cash flow = $\$115 + \$210 - \$28 = \297

AACSB: Analytic

Blooms: Apply

Difficulty level: 2 Medium

Topic: Financial Cash Flow

77.

Knickerdoodles, Inc.		
	2010	2011
Sales	\$ 740	\$ 785
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Cash	70	75
Accounts receivables	563	502
Current liabilities	390	405
Inventory	662	640
Long-term debt	340	410
Net fixed assets	1,680	1,413
Common stock	700	235
Tax rate	35%	35%

What is the cash flow of the firm for 2011?

- A. \$50
- B. \$247
- C. \$297
- D. \$447
- E. \$517

Cash flow of the firm = \$297 - (-\$93) - (-\$57) = \$447

AACSB: Analytic

Blooms: Apply

Difficulty level: 2 Medium

Topic: Financial Cash Flow

78.

Knickerdoodles, Inc.		
	2010	2011
Sales	\$ 740	\$ 785
COGS	430	460
Interest	33	35
Dividends	16	17
Depreciation	250	210
Cash	70	75
Accounts receivables	563	502
Current liabilities	390	405
Inventory	662	640
Long-term debt	340	410
Net fixed assets	1,680	1,413
Common stock	700	235
Tax rate	35%	35%

What is net new borrowing for 2011?

- A. -\$70
- B. -\$35
- C. \$35
- D. \$70
- E. \$105

Net new borrowing = \$410 - \$340 = \$70

AACSB: Analytic
Blooms: Apply
Difficulty level: 2 Medium
Topic: Financial Cash Flow

79.

Knickerdoodles, Inc.		
	2010	2011
Sales	\$ 740	\$ 785
COGS	430	460
Interest	33	35
Dividends	16	17
Depreciation	250	210
Cash	70	75
Accounts receivables	563	502
Current liabilities	390	405
Inventory	662	640
Long-term debt	340	410
Net fixed assets	1,680	1,413
Common stock	700	235
Tax rate	35%	35%

What is the cash flow to creditors for 2011?

- A. -\$170
- B. -\$35**
- C. \$135
- D. \$170
- E. \$205

$$\text{Cash flow to creditors} = \$35 - (\$410 - \$340) = -\$35$$

AACSB: Analytic
Blooms: Apply
Difficulty level: 2 Medium
Topic: Financial Cash Flow

80.

Knickerdoodles, Inc.		
	2010	2011
Sales	\$ 740	\$ 785
COGS	430	460
Interest	33	35
Dividends	16	17
Depreciation	250	210
Cash	70	75
Accounts receivables	563	502
Current liabilities	390	405
Inventory	662	640
Long-term debt	340	410
Net fixed assets	1,680	1,413
Common stock	700	235
Tax rate	35%	35%

What is the cash flow to stockholders for 2011?

- A. \$408
- B. \$417
- C. \$452
- D. \$482
- E. \$503

Cash flow to stockholders = $\$447 - (-\$35) = \$482$; or, Cash flow to stockholders = $\$17 - (\$235 - \$700) = \482

AACSB: Analytic

Blooms: Apply

Difficulty level: 2 Medium

Topic: Financial Cash Flow

81.

	<u>2011</u>
Cost of goods sold	\$3,210
Interest	\$215
Dividends	\$160
Depreciation	\$375
Change in retained earnings	\$360
Tax rate	35%

What is the taxable income for 2011?

- A. \$360
- B. \$520
- C. \$640
- D. \$780
- E. \$800

Net income = \$160 + \$360 = \$520; Taxable income = \$520 ÷ (1 - .35) = \$800

AACSB: Analytic

Blooms: Apply

Difficulty level: 2 Medium

Topic: Taxes

82.

	<u>2011</u>
Cost of goods sold	\$3,210
Interest	\$215
Dividends	\$160
Depreciation	\$375
Change in retained earnings	\$360
Tax rate	35%

What is the operating cash flow for 2011?

- A. \$520
- B. \$800
- C. \$1,015
- D. \$1,110
- E. \$1,390

Earnings before interest and taxes = \$800 + \$215 = \$1,015; Operating cash flow = \$1,015 + \$375 - (\$800 - \$520) = \$1,110

AACSB: Analytic

Blooms: Apply

Difficulty level: 2 Medium

Topic: Financial Cash Flow

83.

	<u>2011</u>
Cost of goods sold	\$3,210
Interest	\$215
Dividends	\$160
Depreciation	\$375
Change in retained earnings	\$360
Tax rate	35%

What are the sales for 2011?

- A. \$4,225
- B. \$4,385
- C. \$4,600
- D. \$4,815
- E. \$5,000

$$\text{Sales} = \$1,015 + \$375 + \$3,210 = \$4,600$$

AACSB: Analytic

Blooms: Apply

Difficulty level: 2 Medium

Topic: The Income Statement

84. Calculate net income based on the following information. Sales are \$250, cost of goods sold is \$160, depreciation expense is \$35, interest paid is \$20, and the tax rate is 34%.

- A. \$11.90
- B. \$23.10
- C. \$35.00
- D. \$36.30
- E. \$46.20

$$((\text{Sales} - \text{COGS}) - \text{Depreciation} - \text{Interest}) - \text{Taxes} = \text{Net Income} ((\$250 - \$160) - \$35 - \$20) - \$11.9 = \$23.10$$

AACSB: Analytic

Blooms: Apply

Essay Questions

85. What is a liquid asset and why is it necessary for a firm to maintain a reasonable level of liquid assets?

Liquid assets are those that can be sold quickly with little or no loss in value. A firm that has sufficient liquidity will be less likely to experience financial distress.

AACSB: Reflective Thinking
Blooms: Analyze
Difficulty level: 1 Easy
Topic: The Balance Sheet

86. Why is interest expense excluded from the operating cash flow calculation?

Operating cash flow is designed to represent the cash flow a firm generates from its day-to-day operating activities. Interest expense arises from a financing decision and thus should be considered as a cash flow to creditors.

AACSB: Reflective Thinking
Blooms: Analyze
Difficulty level: 2 Medium
Topic: Financial Cash Flow

87. Explain why the income statement is not a good representation of cash flow.

Most income statements contain some noncash items, so these must be accounted for when calculating cash flows. More importantly, however, since GAAP is used to create income statements, revenues and expenses are booked when they accrue, not when their corresponding cash flows occur.

AACSB: Reflective Thinking

Blooms: Analyze

Difficulty level: 2 Medium

Topic: The Accounting Statement

88. Discuss the difference between book values and market values on the balance sheet and explain which is more important to the financial manager and why.

The accounts on the balance sheet are generally carried at historical cost, not market values. Although the book value of current assets and current liabilities may closely approximate market values, the same cannot be said for the rest of the balance sheet accounts. Ultimately, the financial manager should focus on the firm's stock price, which is a market value measure. Hence, market values are more meaningful than book values.

AACSB: Reflective Thinking

Blooms: Analyze

Difficulty level: 2 Medium

Topic: The Balance Sheet

89. Note that in all of our cash flow computations to determine cash flow of the firm, we never include the addition to retained earnings. Why not? Is this an oversight?

The addition to retained earnings is not a cash flow. It is simply an accounting entry that reconciles the balance sheet. Any additions to retained earnings will show up as cash flow changes in other balance sheet accounts.

AACSB: Reflective Thinking

Blooms: Analyze

Difficulty level: 3 Hard

Topic: Financial Cash Flow

90. Note that we added depreciation back to operating cash flow and to additions to fixed assets. Why add it back twice? Isn't this double-counting?

In both cases, depreciation is added back because it was previously subtracted when obtaining ending balances of net income and fixed assets. Also, since depreciation is a noncash expense, we need to add it back in both instances, so there is no double counting.

AACSB: Reflective Thinking

Blooms: Analyze

Difficulty level: 3 Hard

Topic: Financial Cash Flow

91. Sometimes when businesses are critically delinquent on their tax liabilities, the tax authority comes in and literally seizes the business by chasing all of the employees out of the building and changing the locks. What does this tell you about the importance of taxes relative to our discussion of cash flow? Why might a business owner want to avoid such an occurrence?

Taxes must be paid in cash, and in this case, they are one of the most important components of cash flow. The reputation of a business can undergo irreparable harm if word gets out that the tax authorities have confiscated the business, even if only for a couple of hours until the business owner can come up with the money to clear up the tax problem. The bottom line is if the owner can't come up with the cash, the tax authority has effectively put them out of business.

AACSB: Reflective Thinking

Blooms: Analyze

Difficulty level: 2 Medium

Topic: Taxes

92. Interpret, in words, what cash flow of the firm represents by discussing operating cash flow, changes in net working capital, and additions to fixed assets.

Operating cash flow is the cash flow a firm generates from its day-to-day operations. In other words, it is the cash inflow generated as a result of putting the firm's assets to work. Changes in net working capital and fixed assets represent investments a firm makes in these assets. That is, a firm typically takes some of the cash flow it generates from using assets and reinvests it in new assets. Cash flow of the firm, then, is the cash flow a firm generates by employing its assets, net of any acquisitions.

AACSB: Reflective Thinking

Blooms: Evaluate

Difficulty level: 2 Medium

Topic: Financial Cash Flow

93. Why is cash flow management important?

Cash flow management is important because managers could manipulate cash flows which present inaccurate information about the firm. Second, GAAP accounting principles allow significant subjective decisions to be made in many key areas. The use of cash flow as a metric to evaluate a company comes from the idea that there is less subjectivity involved and therefore, harder to spin the numbers.

AACSB: Reflective Thinking

Blooms: Analyze

Difficulty level: 2 Medium

Topic: Financial Cash Flow

94. What is operating cash flow and how does it differ from the total cash flow to the firm?

Several types of cash flow are relevant to understanding the financial situation of the firm. Operating cash flow, defined as earnings before interest plus depreciation minus taxes, measures the cash generated from operations not counting capital spending or working capital requirements. It is usually positive; a firm is in trouble if operating cash flow is negative for a long time because the firm is not generating enough cash to pay operating costs. Total cash flow of the firm includes adjustments for capital spending and additions to net working capital. It will frequently be negative. When a firm is growing at a rapid rate, spending on inventory and fixed assets can be higher than operating cash flow.

We start with net income and add back non-cash expenses and adjust for changes in current assets + liabilities (other than cash & notes payable). The result is operating cash flow)

AACSB: Reflective Thinking

Blooms: Analyze

Difficulty level: 2 Medium

Topic: Financial Cash Flow