Reading 33

ANALYZING STATEMENTS OF CASH FLOWS II

1. (B) $ 24 million.

Explanation

Free cash flow to the firm = net income + noncash charges + after-tax interest – fixed capital investment – working capital investment.

Net income is $43.7 million.

Noncash charges are $4.2 million (depreciation expense).

No interest expense is shown.

Fixed capital investment is $35 million purchased – $15 million sold = $20 million.

Working capital investment is $1.5 million increase in accounts receivable + $2.3 million decrease in accounts payable = $3.8 million. (Both are uses of cash)

FCFF = $43.7 million + $4.2 million – $20 million – $3.8 million = $24.1 million.

(Module 33.1, LOS 33.b)

2. (B) $18 million.

Explanation

Free cash flow to equity (FCFE) is generally defined as cash flow from operations (CFO) less net fixed capital expenditures plus net borrowing. No information on borrowing is given here, so FCFE = 20 – (5 – 3) = $18 million.

(Module 33.1, LOS 33.b)

3. (B) operating cash flow for the period.

Explanation

There are two formats for a common-size cash flow statement, expressing each type of outflow as a percentage of total cash outflows or as a percentage of total revenue for the period. Operating cash flow for the period mixes inflows and outflows and is not used to calculate percentage flows for payment made.

(Module 33.1, LOS 33.a)

4. (C) total cash flows.

Explanation

Common-size cash flow statements show each cash flow item as a percentage of revenue or show each cash flow outflow as a percentage of all cash outflows and each cash inflow as a percentage of all cash inflows.

(Module 33.1, LOS 33.b)

5. (B) No impact No

Explanation

Decreasing accounts payable turnover saves cash by delaying payments to suppliers. The result is an operating source of cash, not a financing source. Decreasing accounts payable turnover is not a sustainable source of cash flow because suppliers will refuse to extend credit, at some point, if payment is slower and slower.

(Module 33.1, LOS 33.a)

6. (B) Reinvestment ratio Cash-to-income ratio

Explanation

The reinvestment ratio measures a firm's ability to acquire long-term assets with cash flows from operations. In contrast, the investing and financing ratio, which is more comprehensive, measures the firm's ability to purchase assets, satisfy debts, and pay dividends.

The cash-to-income ratio measures the ability to generate cash from a firm's operations and is a performance ratio for cash flow analysis purposes. The debt payment ratio measures the firm's ability to satisfy long-term debt with cash flow from operations but it is more of a coverage ratio than a performance ratio.

(Module 33.1, LOS 33.b)

7. (A) 0.50.

Explanation

The reinvestment ratio is CFO divided by cash paid for long-term assets: €1,300 / € 2,600 = 0.5. (Note that on this cash flow statement, CFI includes interest and dividends received and CFF includes interest paid, which is acceptable under IFRS.)

(Module 33.1, LOS 33.b).

8. (B) $ 2,900.

Explanation

FCFF = CFO + Int(1 − tax rate) − capital expenditures

$$FCFF = 3{,}500 + \left[195 \times \left(1 - \left(\frac{1{,}540}{4{,}400}\right)\right)\right] - 727 = 2{,}899.75 \approx 2{,}900$$

(Module 33.1, LOS 33.b)

9. (C) Both statements are correct.

Explanation

A cash flow statement can be presented in common-size format by expressing each line item as a percentage of total revenue or by expressing each inflow of cash as a percentage of total cash inflows and each outflow as a percentage of total cash outflows. Expressing each line item of the cash flow statement as a percentage of revenue is useful in forecasting future cash flows since revenue usually drives the forecast.

(Module 33.1, LOS 33.a)