What is Cash Flow Analysis?

Worksheet

Cash flow analysis evaluates a company's cash generation and the quality-of-earnings ratio, QoE = Operating Cash Flow Net Income, where a ratio near or above 1 signals that reported profits are backed by real cash.

Questions

1. QoE ratio formula is:
A) Net Income Revenue
B) Operating Cash Flow Net Income
C) Net Income Total Assets
D) Cash Current Liabilities

2. Net income = $500,000, operating cash flow = $150,000. QoE ratio?
A) 3.33
B) 0.30
C) 1.50
D) 0.15

3. A QoE ratio consistently below 1 over several years is a sign of:
A) Strong cash generation
B) Possible earnings quality problems
C) Excess cash on hand
D) Conservative accounting

4. Which activity section includes debt repayment?
A) Operating
B) Investing
C) Financing
D) Retained earnings

5. A company reports net income of $350,000 and operating cash flow of $420,000. Compute the quality of earnings ratio and interpret it.

6. A company reports net income of $500,000 but operating cash flow of only $150,000. What does this suggest?

7. Operating cash flow is $200,000, investing activities use $150,000 for equipment, and financing activities include $50,000 of debt repayment. What is the net change in cash?

8. Define: What is the quality of earnings (QoE) ratio?

9. Define: What does a QoE ratio below 1 suggest?

10. Define: What are the three sections of the cash flow statement?

Answer Key

1. B) Operating Cash Flow Net Income - QoE = Operating Cash Flow Net Income.
2. B) 0.30 - 150,000/500,000 = 0.30.
3. B) Possible earnings quality problems - It suggests reported profits aren't converting to cash, a red flag.
4. C) Financing - Debt repayments and equity/debt issuances belong in financing activities.
5. QoE = Operating Cash Flow Net Income QoE = 420,000 350,000 QoE = 1.2, meaning cash flow exceeds reported profit - high quality earnings
6. QoE = 150,000 500,000 = 0.3 A ratio well below 1 suggests profits are not backed by cash Possible causes: aggressive revenue recognition, rising receivables, or inventory buildup - warrants further investigation
7. Net change in cash = Operating CF + Investing CF + Financing CF Net change = 200,000 + (150,000) + (50,000) Net change = $0 - cash balance stayed flat this period
8. Operating Cash Flow Net Income - it checks whether reported profit is backed by real cash.
9. Net income may be inflated by accruals, aggressive revenue recognition, or rising receivables/inventory.
10. Operating, investing, and financing activities.