CHARTA LEARNING · LESSON NOTES

Cash flow and balance sheet quality

Financial Statement Analysis

1 A story: the cash that was borrowed

- Harlow: operating cash flow 120 last year, 200 this year
- Management: proof of a stronger business
- Maya asks: where did the extra cash come from?
- And will it happen again next year?

IN THE LESSON

- Imagine a friend who tells you their bank balance doubled this month.
- Impressive.
- Then you learn they stopped paying their bills, and the money is simply sitting there until the bills arrive.
- The balance is real, but the improvement is not.
- Companies can do the same thing.
- Maya is reading Harlow Components, whose operating cash flow jumped from one hundred and twenty to two hundred, in millions.
- Management calls it proof of a stronger business.
- Maya asks a different question: where did the extra cash come from, and will it happen again next year?
- That question is the heart of cash flow quality.

2 What a high quality cash flow looks like

- Positive
- From sustainable core operations
- Broadly in line with net income over time
- Not boosted by timing moves

IN THE LESSON

- Cash flow quality is judged mainly through operating cash flow, the cash a business makes from its day to day trading.
- Remember from Level One that operating cash flow starts with net income and adjusts for non cash items and for changes in working capital.
- High quality has four features.
- It is positive.
- It comes from sustainable operations, meaning the core business and not a one off.
- It is broadly consistent with net income over time, because over a long stretch profit should turn into cash.
- And it is not boosted by timing moves, such as paying suppliers later or collecting from customers early.
- The last feature is the one most often broken.

3 Example 1: what is the 200 made of?

Harlow reconciliation, in millions

Net income + depreciation	100 + 60	**160**
Receivables and inventory up	−20 − 20	**−40**
Trade payables up	240 − 160	**+80**
Operating cash flow	160 − 40 + 80	**200**

IN THE LESSON

- Maya starts by rebuilding the number.
- Harlow's net income is one hundred.
- Add back depreciation of sixty, a non cash charge, and you have one hundred and sixty.
- Now working capital.
- Receivables rose by twenty, which uses cash, and inventory rose by twenty, which uses cash too, so together they take away forty.
- Finally, trade payables rose by eighty, from one hundred and sixty to two hundred and forty.
- Owing suppliers more is a source of cash, so that adds eighty.
- One hundred and sixty, less forty, plus eighty, is two hundred.
- The reconciliation works, and the largest single item is the change in payables.

4 Example 1, step 2: measure the supplier stretch

Cost of sales 1,460 a year = 4 a day

Days payable last year	160 ÷ 4	**40 days**
Days payable this year	240 ÷ 4	**60 days**
Cash from paying later	240 − 160	**80**
Cash flow without it	200 − 80	**120**

A one-off release, not a trend

IN THE LESSON

- Next Maya asks how fast Harlow actually pays its suppliers.
- Cost of sales is fourteen hundred and sixty a year, which is four a day, using three hundred and sixty five days.
- This stands in for purchases.
- Last year payables of one hundred and sixty meant forty days of cost of sales.
- This year payables of two hundred and forty mean sixty days.
- Harlow has moved from paying in forty days to paying in sixty.
- That change released eighty of cash, one time only.
- Take it out and operating cash flow is one hundred and twenty.
- The two thirds rise was entirely the suppliers' money, and the underlying business grew by nothing.

5 The same cash flow, three views

Operating cash flow (millions)

Last year	**120**
This year, reported	**200**
Without the stretch	**120**

The jump was timing, not trading

IN THE LESSON

- Here are the three numbers as bars.
- The vertical axis is operating cash flow in millions.
- The first bar is last year, one hundred and twenty.
- The second is this year as reported, two hundred, which looks like a big step up.
- The third bar is this year without the supplier stretch, back at one hundred and twenty.
- Compare the first and third bars and you see the truth: nothing changed in the underlying cash generation.
- Now think about next year.
- Suppliers have said they will not accept terms beyond sixty days, so the stretch cannot repeat.
- If it simply stops, operating cash flow stays near one hundred and twenty, and the fall from two hundred will look like decline when it is really the absence of this year's help.

6 Where interest and dividends are shown

Placement of items, IFRS (IAS 7) vs US GAAP

Item	IFRS | US GAAP
Interest paid	Op or fin | Operating
Interest received	Op or inv | Operating
Dividends paid	Op or fin | Financing

IN THE LESSON

- There is a second reason to adjust, and it is about comparability rather than manipulation.
- Under International Accounting Standard seven, the standard for the cash flow statement, companies have choices.
- Interest paid and dividends paid may be shown in operating or in financing activities.
- Interest received and dividends received may be shown in operating or in investing.
- Under US generally accepted accounting principles the interest lines are fixed: interest paid and interest received go in operating, and dividends paid go in financing.
- So two identical firms can report different operating cash flow just by where they put the interest.
- A newer standard, I F R S eighteen, narrows these choices, but the comparability point stays.

7 Example 2: put Harlow on the peer's basis

Reported 200; interest paid 30, shown in financing

Reported operating cash flow		**200**
Less supplier stretch	200 − 80	**120**
Less interest, peer basis	120 − 30	**90**
Last year, same basis	120 − 30	**90**

Comparable: 90 both years

IN THE LESSON

- Now Maya compares Harlow with Stanway, a peer reporting under US GAAP.
- Harlow reports under I F R S and shows its thirty of interest paid in financing.
- Stanway must show interest paid in operating.
- To compare fairly, Maya moves Harlow's interest into operating.
- Start from the reported two hundred.
- Take out the eighty from the supplier stretch, leaving one hundred and twenty.
- Then take out thirty of interest, leaving ninety.
- That is the figure to set against Stanway.
- And last year, put on the same basis, was also ninety, since payables were steady and interest was the same.
- So on a like for like footing, Harlow's operating cash flow did not move at all.

8 A story: the tidy cupboard

- A balance sheet always balances, so that proves nothing
- Test 1: complete, nothing kept off the sheet
- Test 2: unbiased, judgement items fairly measured
- Test 3: clear, items classified where they belong

IN THE LESSON

- Picture a cupboard that looks perfectly tidy.
- Everything fits and the door closes.
- But a cupboard can be tidy and still hide a bag stuffed behind the boxes, hold things labelled wrongly, and contain items nobody has looked at in years.
- A balance sheet is like that.
- It always balances, because assets equal liabilities plus equity by construction.
- That tells you nothing about quality.
- A high quality balance sheet passes three tests: it is complete, it is unbiasedly measured, and it is clearly presented.
- Each test catches a different way that figures can mislead while still adding up.

9 Three tests, three places to hide

A high quality balance sheet is

Complete → Unbiased → Clear

IN THE LESSON

- This picture shows the three tests as three boxes, and passing one tells you nothing about the others.
- Start on the left with complete.
- It asks what is missing.
- An obligation can exist in substance and still be off the page, such as a guarantee of someone else's debt.
- The middle box is unbiased measurement.
- It asks whether the figures that are on the page were estimated fairly, especially items with no market price to check against.
- The box on the right is clear presentation.
- It asks whether you can see what each item is, or whether something awkward has been folded into a line called other.
- A sheet can pass the first and third and still fail the second.

10 Test 1: is it complete?

- Purchase commitments sitting only in the notes
- Guarantees of other parties' debt
- Structured entities holding assets and debt apart
- Factoring with recourse: a loan in substance

IN THE LESSON

- Completeness means obligations are not hidden.
- Here are the usual hiding places.
- Purchase commitments, where a company has promised to buy goods or services in future, often appear only in the notes.
- Guarantees, where it has promised to pay someone else's debt if they fail.
- Structured entities, separate vehicles that hold assets and debt away from the main balance sheet.
- And factoring with recourse, where receivables are sold to a bank but the company must compensate the bank if customers do not pay.
- In substance the company has borrowed against its receivables, and the risk never left.
- The balance sheet looks smaller and safer than the reality.

11 Test 2: is it measured without bias?

- Goodwill and other intangibles
- Pension obligations: discount rate, lifespans
- Level 3 fair values: the firm's own model
- Reserves and provisions

IN THE LESSON

- The second test concerns items that rely on judgement.
- Goodwill and other intangibles, because their value rests on forecasts.
- Pension obligations, which depend on assumptions about discount rates and lifespans.
- Fair value estimates that use unobservable inputs, called Level Three, which are valued by the company's own model rather than a market price.
- And reserves and provisions, which are management's estimates of future costs.
- None of these is wrong by definition.
- But bias can hide in them, because nobody can check against a price.
- Large goodwill relative to equity signals exposure to impairment, which is a write down that cuts both assets and equity.

12 Test 3: is it clearly presented, and the warning signs

- Presentation: receivables not buried in other assets
- Sign: goodwill rising with no matching earnings
- Sign: heavy use of Level 3 fair values
- Sign: unusual changes in classification

IN THE LESSON

- The third test is clear presentation.
- Items should be classified sensibly.
- For example, receivables should not be buried in a line called other assets, and borrowings should not be hidden within trade payables.
- Beyond the three tests, there are practical signs of weakness for an analyst to look for.
- Goodwill that keeps rising without matching earnings from the businesses bought.
- Heavy and growing use of Level Three fair values.
- And unusual changes in classification, such as an item moving from one line to another in the year it would have hurt a ratio.
- Each sign is a prompt to dig into the notes, not proof of wrongdoing.

13 Example 3: how much rests on judgement?

Equity 1,200; goodwill 900; Level 3 assets 400

Goodwill to equity	900 ÷ 1,200	**75%**
Level 3 to equity	400 ÷ 1,200	**33%**
Judgement items to equity	1,300 ÷ 1,200	**108%**
A 30% goodwill write-down	900 × 0.30	**270**

Equity after the write-down: 930

IN THE LESSON

- Let us put numbers on it.
- A different company, an illustration, has equity of twelve hundred, goodwill of nine hundred from past deals, and four hundred of assets valued with Level Three inputs.
- Goodwill to equity is nine hundred over twelve hundred, which is seventy five per cent.
- Level Three to equity is four hundred over twelve hundred, a third.
- Together, thirteen hundred of judgement items against twelve hundred of equity is about one hundred and eight per cent, more than all the equity.
- Now suppose the acquired units earned less than planned and thirty per cent of goodwill is written off.
- That is two hundred and seventy, and equity falls to nine hundred and thirty.

14 From judging to adjusting

- Add off-balance-sheet obligations to liabilities
- Treat a pension deficit as debt
- Test goodwill; write it down or exclude it
- Question Level 3 values and capitalising
- Recompute leverage and coverage on the new basis

IN THE LESSON

- Spotting the signs is the first half.
- Judging quality means adjusting the reported figures towards economic reality and then recomputing the ratios.
- There are four adjustments.
- Add off balance sheet obligations, such as guarantees or recourse factoring, to liabilities.
- Treat a pension deficit as debt, since it is a real claim on the company's cash.
- Check goodwill against how the acquired business is performing, and consider writing it down, or excluding it when comparing companies.
- And ask whether Level Three values or aggressive capitalising inflate the assets.
- After that, recompute leverage and coverage on the adjusted basis.
- The rule that keeps you honest is that every adjustment must have a matching entry, so the adjusted sheet still balances.

15 Adjusted debt to equity

Adjusted D/E = (Debt + factoring + pension deficit)
÷ (Equity − goodwill written off)

Reported debt	Borrowings on the sheet
Receivables sold with recourse	Recourse factoring: a loan
Pension deficit	Treated as debt
Reported equity	Equity as reported
Impaired goodwill	Judged no longer earning

IN THE LESSON

- Here is the adjusted leverage ratio.
- Start with reported debt.
- Add the receivables sold with recourse, because in substance they are a loan.
- Add the pension deficit, treated as debt.
- That gives adjusted debt.
- For the bottom, take reported equity and subtract the goodwill that the analyst judges to be impaired.
- Adjusting a ratio like this pushes numerator and denominator in opposite directions, so it moves fast.
- A bigger top over a smaller bottom can turn a comfortable looking ratio into a stretched one.
- Notice the balancing logic.
- Factoring adds debt and receivables together.
- The pension deficit moves from other liabilities to debt.
- The goodwill write off removes an asset and equity together.

16 Example 4: Harlow, adjusted

Reported: debt 400, equity 800, D/E 0.50

Recourse factoring	debt +150, receivables +150	**debt 550**
Pension deficit	debt +100, other liab. −100	**debt 650**
Goodwill written off	equity −200, assets −200	**equity 600**
Adjusted debt to equity	650 ÷ 600	**1.08**

IN THE LESSON

- Back to Harlow's balance sheet.
- Reported debt is four hundred and equity is eight hundred, so debt to equity is zero point five zero.
- In the notes Maya finds three things.
- One hundred and fifty of receivables sold with recourse, a pension deficit of one hundred carried in other liabilities, and two hundred of goodwill from a unit now making losses.
- Ignore tax.
- Add one hundred and fifty to debt, with receivables coming back onto the sheet.
- Add one hundred to debt, taken out of other liabilities.
- Write off the goodwill, which lowers assets and equity by two hundred.
- Adjusted debt is six hundred and fifty, adjusted equity is six hundred, and the ratio is about one point zero eight.

17 How the ratio climbs, step by step

Debt to equity (times)

Reported	**0.50**
+ factoring	**0.69**
+ pension	**0.81**
+ goodwill off	**1.08**

Same company, adjusted three times

IN THE LESSON

- This picture shows the climb.
- The vertical axis is debt to equity, and each bar adds one adjustment.
- The first bar is the reported ratio, zero point five zero.
- The second bar adds the factoring, so debt is five hundred and fifty over eight hundred, about zero point six nine.
- The third adds the pension deficit, six hundred and fifty over eight hundred, about zero point eight one.
- The fourth writes off the goodwill, six hundred and fifty over six hundred, about one point zero eight.
- Nothing was borrowed during these three steps.
- The company is exactly as it was, but the reported ratio understated the leverage by more than half, and a lender using the reported figure would have been misled.

18 Example 4, step 2: coverage

Profit before impairment 180; interest 40 as reported

Coverage as reported	180 ÷ 40	**4.50**
Extra debt to price	150 + 100	**250**
Extra interest at 6%	250 × 0.06	**15**
Adjusted coverage	180 ÷ (40 + 15)	**3.27**

IN THE LESSON

- Maya does the same for coverage, the number of times earnings cover interest.
- Harlow's operating profit before any impairment is one hundred and eighty and its interest cost is forty, so coverage as reported is four point five times.
- The extra debt is two hundred and fifty, the factoring plus the pension deficit.
- Assume Maya prices it at six per cent, which adds fifteen of interest.
- Adjusted interest is fifty five.
- Coverage falls to one hundred and eighty over fifty five, about three point two seven times.
- Still above one, so Harlow is not in trouble.
- But a lender who set a limit of four times on the reported figure would find the adjusted company is well outside it, and that is the real finding.

19 Four mistakes to avoid

- 1. A cash flow jump praised without asking its cause
- 2. Balance sheet assumed neutral because it balances
- 3. Liability added with no matching adjustment
- 4. Unqualified audit opinion read as low risk

IN THE LESSON

- Before we move on, the slips that cost marks.
- One.
- Praising a jump in operating cash flow without asking what caused it.
- If it came from delaying supplier payments, it is a loan from suppliers, not quality.
- Two.
- Assuming the balance sheet is neutral because it balances.
- Judgement shapes most of the large items.
- Three.
- Adding a liability without the matching adjustment to equity or assets, so the adjusted figures no longer balance.
- Four.
- Relying only on the audit opinion as a measure of risk.
- An unqualified opinion says the statements are fairly presented.
- It does not say the company is low risk.
- Keep these four in mind through the rest of the lesson.

20 Cash flow quality: the signs, side by side

- Good: positive, steady, core, at least in line with income
- Poor: receivables sold, payables stretched, stock run down
- Poor: cash growth from working capital while earnings stall
- Poor: spending capitalised so outflow moves to investing

IN THE LESSON

- Now let us gather the signs of cash flow quality into one checklist.
- Operating cash flow is harder to manipulate than accrual earnings, but not immune.
- Good signs are that operating cash flow is positive, steady, driven by core operations, and at least in line with net income over time.
- Poor signs are operating cash flow boosted by selling receivables, stretching supplier payments or running down inventory.
- Another poor sign is growth in operating cash flow that comes from working capital while earnings stall.
- And a fourth is capitalising spending, so the outflow shows up in investing instead of operating.
- Under International Accounting Standard seven, interest and dividend choices also affect comparability.

21 Two checks: conversion and free cash flow

Cash conversion = OCF ÷ net income
FCF = OCF − capital expenditure

OCF: operating cash flow	Cash from day to day trading
Net income	Profit on an accrual basis
Capital expenditure	Spending on long-lived assets
FCF: free cash flow	Cash left after investing

IN THE LESSON

- Two simple measures turn this checklist into numbers.
- The first is cash conversion, operating cash flow divided by net income.
- Over several years a healthy company converts close to one, or a bit above, because profit eventually turns into cash.
- A ratio that swings wildly, or sits far below one, deserves questions.
- The second measure is free cash flow, which is operating cash flow minus capital expenditure.
- It shows whether the business funds itself.
- Because capital expenditure includes the spending that sits in investing, free cash flow counts both sections of the cash flow statement.
- So moving an outflow from operating to investing changes the first measure but leaves the second alone.

22 Example 5: steady versus erratic conversion

Net income 100 each year; OCF ÷ net income

Year	P | Q
Year 1	1.06 | 0.40
Year 2	1.02 | 0.60
Year 3	1.07 | 1.82
Total OCF, 3 years	315 | 282

IN THE LESSON

- Look at two companies, P and Q.
- Both report net income of one hundred in each of three years.
- Company P's operating cash flow is one hundred and six, one hundred and two, and one hundred and seven.
- Its cash conversion is close to one every year, and slightly above, which is just what we want.
- Company Q's operating cash flow is forty, sixty, and one hundred and eighty two.
- Its conversion is zero point four, zero point six, and then one point eight two.
- Q's total over three years is two hundred and eighty two, not far from P's three hundred and fifteen, so an analyst looking only at the total could be fooled.
- But the swing, and a last year surge, suggest timing effects.
- Ask what drove year three.

23 Example 6: capitalising moves the outflow

Cash before development 420; development 60; other capex 110

A: operating cash flow	420 − 60	**360**
B: operating cash flow	development in investing	**420**
A: free cash flow	360 − 110	**250**
B: free cash flow	420 − (110 + 60)	**250**

B's OCF is 17% higher on identical cash

IN THE LESSON

- Last, the classification trick.
- Two illustrative software companies each generate four hundred and twenty of cash before development spending.
- Each spends sixty on development and a further one hundred and ten on other capital expenditure.
- Company A expenses the development, so its operating cash flow is four hundred and twenty minus sixty, which is three hundred and sixty.
- Company B capitalises it.
- Its operating cash flow is the full four hundred and twenty, with the sixty shown in investing.
- B's operating cash flow looks about seventeen per cent higher.
- Now free cash flow.
- A is three hundred and sixty minus one hundred and ten, which is two hundred and fifty.
- B is four hundred and twenty minus one hundred and seventy, also two hundred and fifty.
- Same cash.

24 Same cash, different line

Cash (millions)

A: OCF	**360**
B: OCF	**420**
A: FCF	**250**
B: FCF	**250**

Free cash flow is unchanged by the label

IN THE LESSON

- Here is Example Six as bars.
- The vertical axis is cash in millions.
- Compare the first two bars, operating cash flow for A and for B.
- B looks much stronger, four hundred and twenty against three hundred and sixty.
- Now compare the last two bars, free cash flow.
- Both are two hundred and fifty.
- Capitalising a cost does not reduce what is spent.
- It decides which section of the statement records the spending.
- That is why an analyst should look at free cash flow as well as operating cash flow, and why a screen that ranks companies only on operating cash flow can reward the firm that capitalises the most.
- The trap, again, is praising cash flow that rose only because of a classification or timing change.

25 A story: asking around before you lend

- Notes: instruments, fair value levels, contingencies
- Management commentary: principal risks and uncertainties
- Auditor's report: an independent view
- Filings, proxy statements, press, market prices

IN THE LESSON

- Suppose a friend asks to borrow money for a business.
- You would not rely on their word alone.
- You would read their plan, ask what a neutral accountant says, check what other lenders think, and look at how they have behaved before.
- Analysts do the same with a company, because risk information is spread over several places.
- The financial statement notes cover financial instruments, the fair value hierarchy, contingencies, commitments and pension assumptions.
- Management commentary discusses principal risks and uncertainties.
- The auditor's report gives an independent view.
- Regulatory filings, proxy statements and the financial press add more.
- And market prices show how investors themselves price the risk.

26 From the company's words to the market's

- Management commentary
- Notes
- Filings, proxy
- Auditor's report
- Press
- Market prices

IN THE LESSON

- This line arranges the sources by who is speaking.
- The line runs from the company's own words on the left to independent views on the right.
- Far left is management commentary, which gives the risks as management sees them.
- Next the notes, which are required and specific.
- Then regulatory filings and proxy statements, which add detail on regulation, pay and governance.
- Moving right we reach the auditor's report, the independent voice inside the annual report.
- Then the financial press, which is outside the company.
- At the far right are market prices, such as credit default swap spreads and equity volatility, which show how investors price the risk and update every day.
- When the left and right disagree, investigate.

27 Reading the auditor's report

- Opinion: unqualified means fairly presented
- Going concern: material uncertainty is flagged
- Key audit matters (ISAs); critical audit matters (US)
- A matter listed is a pointer, not a doubt

IN THE LESSON

- The auditor's report deserves a closer look.
- It states the opinion.
- An unqualified, or unmodified, opinion means the statements are fairly presented.
- It flags any material uncertainty about going concern, which is whether the company can keep operating for the next twelve months.
- And it describes key audit matters under International Standards on Auditing, called critical audit matters in the United States.
- These are the matters of most significance in the audit, often the hardest judgements or the areas of higher assessed risk, such as goodwill impairment or Level Three valuations.
- A key audit matter is a pointer for the reader.
- It does not mean the auditor doubts the company can continue.

28 What a market spread says about risk

Default probability a year ≈ spread ÷ (1 − recovery rate)

Credit default swap spread	Annual cost, as a decimal
Recovery rate	Share of debt recovered
Default probability a year	Market-implied risk of default

IN THE LESSON

- Market prices give a number you can compute.
- A credit default swap is insurance against a borrower's default, and its spread is the yearly cost, quoted in basis points, where one hundred basis points is one per cent.
- A rough link connects the spread to the market's view of default.
- The annual probability of default is about the spread divided by one minus the recovery rate.
- The recovery rate is the share of the debt you expect to get back if default happens.
- So one minus recovery is the loss given default.
- This is an approximation, but it turns a spread into a probability you can compare with what the financial statements suggest.

29 Example 7: the spread and the unqualified opinion

Recovery 40%, so loss given default 60%

Opinion	unqualified	**fair**
Spread 150 bp	0.0150 ÷ 0.60	**2.5%**
Spread 420 bp	0.0420 ÷ 0.60	**7.0%**
Market risk estimate	7.0 ÷ 2.5	**2.8 times**

An unqualified opinion is not a low-risk label

IN THE LESSON

- Let us finish with a case.
- Maya reads a retailer's annual report.
- The auditor's opinion is unqualified.
- The report lists a key audit matter on impairment testing of store assets.
- Over the year, the retailer's five year credit default swap spread widened from one hundred and fifty to four hundred and twenty basis points.
- Assume recovery of forty per cent, so loss given default is sixty per cent.
- At the start the implied probability is zero point zero one five zero over zero point six, which is two point five per cent a year.
- Now it is zero point zero four two zero over zero point six, which is seven per cent.
- The market has nearly tripled its estimate of risk, while the audit opinion said nothing alarming.

30 Recap: what to remember

- Cash flow: sustainable, in line with income
- Adjust: payables stretch, interest placement, capitalising
- Balance sheet: complete, unbiased, clear
- Risk: notes, commentary, audit, filings, press, markets

IN THE LESSON

- Let us pull it together.
- Cash flow quality means positive, sustainable operating cash flow that is broadly in line with net income and not boosted by timing.
- Strip out supplier stretches, receivable sales and inventory run downs, and put interest and dividends on a common basis before comparing.
- Balance sheet quality means complete, unbiased and clear.
- Judge it by adding hidden obligations, treating a pension deficit as debt, testing goodwill and Level Three values, and then recomputing leverage and coverage with matching entries.
- Check free cash flow as well as operating cash flow.
- And look for risk in the notes, commentary, auditor's report, filings, press and market prices, never just in the opinion.

31 Try three quick questions

1. OCF 310; payables rose 50 from paying suppliers later. OCF without it?
   Answer: 310 − 50 = 260
2. Debt 500, equity 900; +100 recourse factoring; −150 goodwill. Adjusted D/E?
   Answer: 600 ÷ 750 = 0.80 (reported 0.56)
3. CDS spread 300 bp, recovery 40%. Default probability a year?
   Answer: 0.03 ÷ 0.60 = 5%

IN THE LESSON

- Now try three quick questions.
- Pause after each one.
- Question one.
- Operating cash flow was three hundred and ten, and trade payables rose by fifty because suppliers were paid later.
- What is operating cash flow without the stretch?
- Three hundred and ten minus fifty is two hundred and sixty.
- Question two.
- Debt is five hundred, equity is nine hundred.
- The notes show one hundred of recourse factoring, and one hundred and fifty of goodwill to be written off.
- What is the adjusted debt to equity?
- Debt becomes six hundred and equity seven hundred and fifty, so zero point eight zero.
- Question three.
- A spread is three hundred basis points and recovery is forty per cent.
- What is the implied default probability?
- Zero point zero three over zero point six is five per cent.