

# TMExam.com

## Printable Flash Cards Section 2

### Ch 4 to 5 in *Essentials*

#### *Version 3.2*

**Directions:** 1) This document can be printed on card stock paper and cut into 4 pieces. This should create 4 equally sized flash cards – a print shop, such as Kinko’s, can probably print and cut these for you for a fee. 2) Use the blank pages at the end of each “section” to create your own flash cards from other material – you may want to print multiples of the last page for this purpose.

All information in this document was cross-referenced with or obtained from *Essentials of Treasury Management, 3rd Ed*, which, itself, is a great compilation of publicly available financial management information. All information in this file is segmented into associated chapters in *Essentials of Treasury Management, 3rd Ed*. This is *not* all of the information in the text, *Essentials of Treasury Management, 3rd Ed* and is not meant to take the place of the book.

A special thanks to <http://www.investopedia.com/> which has proven to be a great resource for explanations and descriptions.

NOTE: TMExam.com does not guarantee that this information is accurate or will be on the Certified Treasury Professional (CTP)® exam. *Essentials of Treasury Management, 3rd Ed* is the body of knowledge for the CTP® exam and these flash cards are not meant to take the place of this text but are meant to be used as a GREAT study aid in conjunction with other study material.

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## Generally Accepted Accounting Principles (GAAP)

Created by the Financial Accounting Standards Board (FASB) to help make sure that financial information is reported uniformly across companies.

There are 4 basic principles of GAAP:

- Historical Cost principle
- Full Disclosure principle
- Revenue Recognition principle
- Matching Principle

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## PCAOB

PCAOB – Public Company Accounting Oversight Board

Created by SOX – monitors all accounting organizations that provide audit services to public companies.

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## Five types of Audit Opinions

**Standard Unqualified** – financial information is fairly represented  
**Unqualified with explanatory paragraph** – immaterial deviations are present.

**Qualified** – Material deviations are present but information is useful

**Adverse** – Material deviations are present and may be misleading

**Disclaimed** – Auditor cannot give an Opinion (for various reasons)

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## Income Statement Components

Income Statement presents Revenues, Expenses, and Profit/Loss for a period.

Revenue – COGS = **Gross Profit**

Gross Profit – Op Expenses = **EBITDA** (Earnings before Interest, taxes, depreciation, and Amortization)

EBITDA – Depreciation – Amortization = **EBIT/Operating Profit**

EBIT – Interest Cost – Taxes = **Net Income (Loss)**

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### Balance Sheet Components

**Balance Sheet** presents the Assets, Liabilities and Owners Equity of the company at a specific point in time.

**Assets** = Liabilities + Owners Equity

**Liabilities** = Assets – Shareholders Equity

**Shareholders Equity** = Assets – Liabilities

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### Opportunity Costs

**Opportunity Costs** – The cost of using a resource compared to what could have been earned in the next best alternative.

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### Statement of Cash Flows

Shows how cash flow is received and used by the company. Uses information from both the Balance Sheet and the Income Statement.

For example:

An increase in a liability is an increase in cash and a decrease in a liability is a decrease in cash.

An increase in assets is a decrease in cash and a decrease in an asset is an increase in cash.

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### Net Present Value (NPV) Internal Rate of Return (IRR), Profitability Index

**Net Present Value (NPV)** – Determines the current value of future expected cash flows minus the current value of cost

**Internal Rate of Return (IRR)** – IRR is the discount rate where the projects outflows = project inflows.

**Profitability Index (PI)** – Determines the ratio of a projects cash inflow's to its overall costs.

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**Three Classifications of Short Term Investments for reporting purposes**

**Trading Securities:** Bought for sale in the near term to create income in the short term

**Held To Maturity:** Securities such as bonds that are purchased and held full term, until their maturity date

**Available for Sale:** Financial assets that are not purchased as held to maturity or trading securities

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**Net Profit Margin, Return on Common Equity**

$$\text{Net Profit Margin} = \frac{\text{NetIncome}}{\text{Sales}}$$

$$\text{Return on Common Equity} = \frac{(\text{NetIncome} - \text{PreferredDividends})}{(\text{TotalEquity} - \text{PreferredStock})}$$

$$= \frac{\text{EarningsAvailableToCommonShareholders}}{\text{CommonEquity}}$$

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**Breakeven Point**

$$\text{Breakeven Point} = \frac{\text{FixedCost}}{\text{PerUnitSell Price} - \text{PerUnitVariableCost}}$$

Determines the amount of units needed to sell before revenue = cost

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**Return On Investment (ROI)**

The amount of profit earned on invested capital.

$$\text{Return on Investment (ROI)} = \frac{\text{NetIncome}}{\text{InvestedCapital}}$$

$$= \frac{\text{NetIncome}}{\text{LTDebt} + \text{Equity}}$$

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**Gross Profit Margin**

$$\text{Gross Profit Margin} = \frac{\text{Gross Profit}}{\text{Revenues}}$$

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**Quick Ratio (Acid Test)**

$$\text{Quick Ratio} = \frac{\text{Cash} + \text{ST Investments} + \text{Accounts Receivables}}{\text{Total Current Liabilities}}$$

**Also called the Acid Test** Shows company's ability to pay back ST Liabilities with its most liquid assets.

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**Current Ratio**

$$\text{Current Ratio} = \frac{\text{Total Current Assets}}{\text{Total Current Liabilities}}$$

Shows the company's ability to pay back current Liabilities with current Assets.

A high Current Ratio is a sign of strong liquidity and a sign of lower risk to lenders and investors.

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**Cash Flow to Total Debt Ratio**

$$\text{Cash Flow to Total Debt Ratio} = \frac{\text{Net Income} + \text{Depreciation}}{\text{ST Debt} + \text{LT Debt}}$$

Helps determine how able a company is to pay its debt with its cash flow.

**Remember: Cash Flow pays off debt, not Revenues. So this information is very important to lenders and investors.**

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**Times Interest Earned**

$$\text{Times Interest Earned (TIE)} = \frac{\text{Operating Profit}}{\text{Interest Expense}} = \frac{\text{EBIT}}{\text{Interest Expense}}$$

TIE determines how many times Operating Profit (EBIT) covers Interest Expense. The more times Interest Expense is covered, the more likely the company is to be able to pay debt down.

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**Residual Income (RI) & Economic Value Added (EVA)**

**RI** Shows profit after the cost of capital is deducted.  
**RI** = Net Income – (Invested Capital x Cost of Capital)

**EVA** Shows the after-tax cash flows minus the cost of capital.  
**EVA** = (EBIT x (1-Tax Rate)) – (WACC x (LT Debt + Equity))

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**Long Term Debt to Capital**

$$\text{LT Debt to Capital} = \frac{\text{LT Debt}}{\text{LT Debt} + \text{Equity}}$$

Determines a company's leverage – the higher this amount, the more the company is financing Capital.

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**Operating Profit Margin, Return on Total Assets**

$$\begin{aligned} \text{Operating Profit Margin} &= \frac{\text{EBIT}}{\text{Revenues}} \\ \text{Return on Total Assets} &= \frac{\text{Net Income}}{\text{Total Assets}} \end{aligned}$$

$$= \frac{\text{Net Income}}{\text{Total Revenue}} \times \frac{\text{Total Revenue}}{\text{Total Assets}}$$

$$= \text{Return On Sales} \times \text{Total Asset Turnover}$$

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**Debt to Tangible Net Worth  
EBITDA Margin**

$$\text{Debt to Tangible Net Worth} = \frac{\text{Total Debt}}{\text{Total Equity} - \text{Intangible Assets}}$$

$$\text{EBITDA Margin} = \frac{\text{EBITDA}}{\text{Revenues}}$$

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**Cash Conversion Efficiency, Net Profit Margin,  
Free Cash Flow (FCF)**

$$\text{Cash Conversion Efficiency} = \frac{\text{Cash Flow From Operations}}{\text{Sales}}$$

$$\text{Net Profit Margin} = \frac{\text{Net Income}}{\text{Total Revenue}}$$

FCF = Net Inc + (depreciation and amortization) – Change in working capital – capital expenses

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**Total Asset Turnover,  
Fixed Asset Turnover**

$$\text{Total Asset Turnover} = \frac{\text{Revenues}}{\text{Total Assets}}$$

$$\text{Fixed Asset Turnover} = \frac{\text{Revenues}}{\text{Net Property, Plant, and Equipment}}$$

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**FV and PV Equations and Uses**

**FV** = PV x (1 + i) <sup>n</sup>  
 Determines Future Value of an investment based on interest rate (i).

$$\text{PV} = \frac{\text{FV}}{(1+i)^n} = \text{FV} \left[ \frac{1}{(1+i)^n} \right]$$

i = Interest rate  
 n = # of Periods

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**Current Asset Turnover**  
**Total Liabilities to Total Assets**

$$\text{Current Asset Turnover} = \frac{\text{Revenues}}{\text{Current Assets}}$$

$$\text{Total Liabilities to Total Assets} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

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**Net Present Value (NPV) Calculations**

$$\begin{aligned} \text{NPV} &= \text{PV of Cash Inflows} - \text{PV of Cash Outflows} \\ &= \text{PV of Cash Inflows} - \text{Cost} \\ &= \frac{C_1}{(1+i)^1} + \frac{C_2}{(1+i)^2} + \frac{C_3}{(1+i)^3} \dots + \frac{C_n}{(1+i)^n} - \text{Cost} \end{aligned}$$

i = Interest Rate (Discount)

n = # of periods

Cost = \$ output

$C_1 C_2 C_3 \dots$  = Cash flow at each time period

**If NPV > 0, Accept Project**

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**Return on Assets**  
**Annualized Cost of Trade Credit**

$$\text{Return on Total Assets} = \frac{\text{Net Income}}{\text{Total Revenue}} \times \frac{\text{Total Revenue}}{\text{Total Assets}}$$

= Return on Sales x Total Asset Turnover

**Annualized Cost of Trade Credit =**

$$\frac{\text{Early Pmt Discount}}{(1 - \text{Early Pmt Discount})} \times \frac{365}{(\text{Net Pmt Period} - \text{Discount Pmt Period})}$$

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**Profitability Index (PI)**  
**Internal Rate of Return (IRR)**

$$\text{Profitability Index (PI)} = \frac{\text{PV of Cash Inflows}}{\text{PV of Cash Outflows}} = \frac{\text{PV of Cash Inflows}}{\text{Cost}}$$

**If PI > 1, Accept Project**

**Internal Rate of Return (IRR)**

IRR is where NPV = 0

**If IRR > WACC, Accept Project**

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**IASB and IFRS**

**International Accounting Standards Board (IASB):** sets accounting standards and is made up of board members from nine countries

**International Financial Reporting Standards (IFRS):** Like GAAP on an international level.

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**Current Assets, Fixed Assets, Intangible Assets**

**Current Assets:** Assets that are likely to be converted to cash in one year

**Fixed Assets:** Capital Assets. Not easily converted into cash and meant to be held long term.

**Intangible Assets:** Assets that do not likely have a finite value. Examples are Goodwill and trademarks

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**Current and Non-Current Liabilities**

**Current Liabilities** are those to be paid in one year or less

**Non-Current Liabilities** are those to be repaid in over 1 year.

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**Three Sections of the Statement of Cash Flows**

**Operating Activities:** Includes cash generated/spent from core business

**Investing Activities:** Includes cash generated/spent on investments such as capital (buildings or equipment) and financial investments (t-bills, etc)

**Financing Activities:** Includes cash generated/spent on debt or dividend payments.

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### Fixed and Variable Cost

**Fixed:** Costs that do not change based on volume of production. For example, if rent is \$1,000 and the company produces 1 item, the cost per item is \$1,000. If the company produces 1,000 items, the cost per item is \$1.

**Variable:** Costs that increase based on volume of production. For example, if it costs \$5 per unit produced, the company will spend \$5 for 1 item, or \$500 for 100 items

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### Low and High Operating Leverage

**Low Operating Leverage:** Lower fixed cost, so requires lower output to cover fixed cost.

**High Operating Leverage:** Higher Fixed cost, so require higher output to cover fixed cost.

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### Semi-Variable Costs

**Semi-Variable:** Has both Fixed and Variable attributes. For example, if computer memory can only be purchased in 10 GB increments at a cost of \$50, the cost is \$5 per GB. So the cost acts like a fixed cost until you need to store 11 GB of information and have to purchase 20 GB of storage

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### When to Make Project Decisions Based on NPV, IRR, PI

**NPV:** Accept project if NPV is  $>0$

**IRR:** Accept project if IRR is  $> WACC$

**PI:** Accept project if PI is  $> 1$

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**Four General Categories of Ratios listed in *Essentials of Treasury Management, 3<sup>rd</sup> Ed***

**Liquidity or Working Capital Ratios**

**Efficiency or Asset Management Ratios**

**Debt Management Ratios**

**Performance Ratios:**

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**Strengths of Ratio Analysis listed in *Essentials of Treasury Management, 3<sup>rd</sup> Ed***

**Easily computed and widely used**

**Information to calculate is easily obtained**

**Allow comparisons between companies**

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**Weaknesses of Ratio Analysis listed in *Essentials of Treasury Management, 3<sup>rd</sup> Ed***

- **Provide historical analysis at a fixed point in time**
- **Should be used in comparison to other companies or industries instead of standing alone for analysis**
- **May not reflect true economic value**
- **Cannot reveal Qualitative value to the company such as CEO value or strategic positioning**
- **Differences in accounting methods make it difficult to compare ratios between companies**

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**Relationship between Funds Sources and Cash Flow**

**Cash Flow Increases:** Decrease in an Asset or Increase in a Liability

**Cash Flow Decreases:** Increase in an Asset or Decrease in a Liability

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**Derivative  
Fixed Charge Coverage**

Derivative: A forward, future, option or swap contract whose value is derived from an underlying financial asset.

$$\text{Fixed Charge Coverage} = \frac{EBIT + LEASEPMTS}{INTERESTEXP + LEASEPMTS}$$

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**Master Budget**

Master Budget: Mainly made up of the operating budget and financial budget.

The operating budget (aka Profit Plan) relates to daily operations and the financial budget relates to your borrowing and investment activities

Financial budget creation steps: 1) develop capital budget 2) develop cash budget. Financial budget is created after the operating budget

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**Budget  
Financial Plan**

Budget: An in-depth plan to use finances over a period of time. Usually short, i.e. 1 month to 2 year period.

Financial Plan: Unlike a budget, is mapped out over a longer period of time, i.e. 5 years +

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**EBITDA Margin  
Free Cash Flow (FCF)**

$$\text{EBITDA Margin} = \frac{EBITDA}{\text{Revenues}}$$

FCF: Net Income + (Depreciation and Amortization) – Chang in non-cash working capital – capital expenditures

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