Question #1 of 44

Robel Company, which pays no dividends, carries out a 3-for-5 reverse split of its common shares. How will this transaction affect Robel's forecasts of its net cash position?

A) No effect on the short-term forecast but less net cash in the longterm forecast.

B) More net cash in both the short-term forecast and the long-term forecast.

C) No effect because this transaction does not affect future cash flows.

Explanation

Stock splits and reverse stock splits do not affect a firm's future cash flows unless dividend yields are increased as a result. These transactions change the number of shares outstanding but they do not raise capital for the firm.

(Study Session 11, Module 37.1, LOS 37.d)

Question #2 of 44

An analyst computes the following ratios for Iridescent Carpeting Inc. and compares the results to the industry averages:

Financial Ratio	Iridescent Carpeting	Industry Average
Current Ratio	2.3x	1.8x
Net Profit Margin	22%	24%
Return on Equity	17%	20%
Total Debt / Total Capital	35%	56%
Times Interest Earned	4.7x	4.1x

Based on the above data, which of the following can the analyst conclude? Iridescent Carpeting:

A) is most likely a younger company than its competitors.

B) has stronger profitability than its competitors.

C) has better short-term liquidity than its competitors.

Explanation

Based on the data provided, the analyst can conclude that Iridescent Carpeting has weaker profitability than its competitors based on the net profit margin and return on equity. The analyst can also conclude that the company has less financial leverage (risk) than the industry average based on the total debt / total capital and the times interest earned ratios. The analyst can conclude that the company has better short-term liquidity than the industry average (i.e., its competitors) based on the current ratio.

(Study Session 11, Module 37.1, LOS 37.b)

Question #3 of 44

The condition that occurs when a company disburses cash too quickly, stretching the company's cash reserves, is *best* described as a:

A) pull on liquidity.

B) liquidity premium.

C) drag on liquidity.

Explanation

When cash payments are made too quickly, the condition is known as a pull on liquidity. A drag on liquidity occurs when cash inflows lag.

(Study Session 11, Module 37.1, LOS 37.a)

Question #4 of 44

Which of the following sources of credit would an analyst *most likely* associate with a borrower of the lowest credit quality?

A) Uncommitted line of credit.

B) Committed line of credit.

C) Revolving line of credit.

Explanation

Committed lines and revolving lines of credit all contain a commitment by a lender to lend up to a maximum amount, at the borrower's option for some period of time. A firm with lower credit quality may have an uncommitted line of credit which offers no guarantee from the lender to provide any specific amount of funds in the future.

(Study Session 11, Module 37.1, LOS 37.g)

Question #5 of 44

The average number of days that it takes to turn raw materials into cash proceeds is a firm's:

A) receivables cycle.

B) operating cycle.

C) inventory turnover cycle.

Explanation

Operating cycle = days of inventory + days of receivables, and is the number of days that it takes to turn raw materials into cash from sales.

(Study Session 11, Module 37.1, LOS 37.c)

Question #6 of 44

A firm records the following cash flows on the same day: $250 million from debt proceeds; $100 million funds transferred to a subsidiary; $125 million in interest payments; and $30 million in tax payments. The net daily cash position:

A) worsened.

B) remained the same.

C) improved.

Explanation

Improving a firm's net daily requires more inflows than outflows. Debt proceeds are cash inflows while funds transferred to a subsidiary, interest and dividend payments, and tax payments are outflows. The net cash change for the day is $250 – $100 – $125 – $30 = –$5 million.

(Study Session 11, Module 37.1, LOS 37.d)

Question #7 of 44

An example of a secondary source of liquidity is:

A) trade credit and bank lines of credit.

B) negotiating debt contracts.

C) cash flow management.

Explanation

Secondary sources of liquidity include negotiating debt contracts, liquidating assets, and filing for bankruptcy protection and reorganization. Primary sources of liquidity include ready cash balances, short-term funds (e.g., trade credit and bank lines of credit), and cash flow management.

(Study Session 11, Module 37.1, LOS 37.a)

Question #8 of 44

Which of the following is NOT a limitation to financial ratio analysis?

A) A firm that operates in only one industry.

B) The need to use judgment.

C) Differences in international accounting practices.

Explanation

If a firm operates in multiple industries, this would limit the value of financial ratio analysis by making it difficult to find comparable industry ratios.

(Study Session 11, Module 37.1, LOS 37.b)

Question #9 of 44

An example of a primary source of liquidity is:

A) filing for bankruptcy.

B) using trade credit from vendors.

C) renegotiating debt agreements.

Explanation

Primary sources of liquidity include cash resulting from selling goods and services, collecting receivables, generating cash from other sources and sources of short-term funding such as trade credit from vendors and lines of credit from banks. Filing for bankruptcy and renegotiating debt agreements are secondary sources of liquidity.

(Study Session 11, Module 37.1, LOS 37.a)

Question #10 of 44

A banker's acceptance that is priced at $99,145 and matures in 72 days at $100,000 has a(n):

A) bond equivalent yield greater than its effective annual yield.

B) discount yield greater than its bond equivalent yield.

C) money market yield greater than its discount yield.

Explanation

The money market yield is the holding period yield times 360/72 and is always greater than the discount yield which is the actual discount from face value times 360/72, since the holding period yield is always greater than the percentage discount from face value. A security's discount yield and its money market yield are always less than its bond equivalent yield, and its effective annual yield is always greater than its bond equivalent yield.

(Study Session 11, Module 37.1, LOS 37.e)

Question #11 of 44

The *least* appropriate security for investing short-term excess cash balances would be:

A) bank certificates of deposit.

B) preferred stock.

C) time deposits.

Explanation

While adjustable-rate preferred is an appropriate security for short-term investment of excess cash balances, other preferred shares are not. Bank certificates of deposit and time deposits can be for appropriately short periods.

(Study Session 11, Module 37.1, LOS 37.d)

Question #12 of 44

Pfluger Company's accounts payable department receives an invoice from a vendor with terms of 2/10 net 30. If Pfluger pays the invoice on its due date, the cost of trade credit is *closest* to:

A) 44.6%.

B) 27.9%.

C) 43.5%.

Explanation

"2/10 net 30" is a discount of 2% of the invoice amount for payment within 10 days, with full payment due in 30 days. Cost of trade credit on day 30 =

(1+0.021−0.02)36530−10−1=44.6%.

(Study Session 11, Module 37.1, LOS 37.f)

Question #13 of 44

A large, creditworthy manufacturing firm would *most likely* get short-term financing by:

A) entering into an agreement for a committed line of credit.

B) issuing commercial paper.

C) factoring its receivables.

Explanation

Large, creditworthy firms can get the lowest cost of financing by issuing commercial paper. Selling receivables to a factor is a higher cost source of funds used by firms with poor credit quality. A committed line of credit requires payment of a fee and represents bank borrowing, which would be attractive to a firm that did not have the size or creditworthiness to issue commercial paper.

(Study Session 11, Module 37.1, LOS 37.g)

Question #14 of 44

Randox Industries has the following investment policy statement: "In order to achieve the safety and liquidity necessary in the investment of excess cash balances, the CFO or his designee may invest excess cash balances in 30-day U.S. Treasury bills, or in banker's acceptances with maturities of less than 31 days or 30-day certificates of deposit, where the credit rating of the issuing bank is A+ or higher." This policy statement is:

A) inappropriate because it is too restrictive.

B) inappropriate because both banker’s acceptances and certificates of deposit are illiquid.

C) appropriate because these are all safe, liquid securities.

Explanation

The policy statement is inappropriate because it is too restrictive. A policy statement should focus on meeting the specific safety and liquidity needs of the firm but should also allow the flexibility to increase yield within these constraints. There are many other securities potentially suitable for cash management that would provide equivalent or better liquidity and safety of principal at least equivalent to that of the securities issued by A+ rated banks.

(Study Session 11, Module 37.1, LOS 37.e)

Question #15 of 44

A 30-day bank certificate of deposit has a holding period yield of 1%. What is the annual yield of this CD on a bond-equivalent basis?

A) 12.17%.

B) 12.00%.

C) 11.83%.

Explanation

The bond-equivalent yield is calculated as the holding period yield times (365 / number of days in the holding period). BEY = 1% × (365/30) = 12.17%.

(Study Session 11, Module 37.1, LOS 37.e)

Question #16 of 44

With respect to inventory management,:

A) a decrease in a firm's days of inventory on hand indicates better inventory management and can lead to increased profits.

B) a firm with inventory turnover higher than the industry average can be expected to have better profitability as a result.

C) an increase in days of inventory on hand can be the result of either good or poor inventory management.

Explanation

An increase in inventory could indicate poor sales and an accumulation of obsolete items or could be the result of a conscious effort to have adequate supplies to avoid losses from not having items to satisfy customer orders (stock outs). Higher-than-average inventory turnover could indicate better inventory management or could indicate that a less than optimal inventory is being maintained by the company.

(Study Session 11, Module 37.1, LOS 37.f)

Question #17 of 44

Which of the following sources of short-term liquidity is considered reliable enough that it can be listed in the footnotes to a firm's financial statements as a source of liquidity?

A) Revolving line of credit.

B) Uncommitted line of credit.

C) Factoring agreement.

Explanation

With an uncommitted line of credit, the lender is not committed to make loans in any amount. A revolving line of credit is typically for a longer period and involves an agreement to lend funds in the future up to some maximum amount. Factoring does not typically involve an agreement for future receivables purchases.

(Study Session 11, Module 37.1, LOS 37.g)

Question #18 of 44

A high cash conversion cycle suggests that a company's investment in working capital is:

A) too high.

B) appropriate.

C) too low.

Explanation

The cash conversion cycle is equal to average days of receivables plus average days of inventory minus average days of payables. High cash conversion cycles relative to those of comparable firms are considered undesirable. A cash conversion cycle that is too high implies that the company has excessive investment in working capital.

(Study Session 11, Module 37.1, LOS 37.c)

Question #19 of 44

An analyst who is evaluating a firm's working capital management would be *least likely* to be concerned if the firm's:

A) total asset turnover is lower than its industry average.

B) operating cycle is shorter than that of its peers.

C) number of days of inventory is higher than that of its peers.

Explanation

A shorter operating cycle will lead to a shorter cash conversion cycle, other things equal, which is an indication of better working capital management. Higher days inventory on hand, compared to peer company averages, will lengthen the cash conversion cycle, an indication of poorer working capital management. Good working capital management would tend to increase a firm's total asset turnover since a given amount of sales can be supported with less working capital (less current assets).

(Study Session 11, Module 37.1, LOS 37.c)

Question #20 of 44

Compared to the prior period, a firm has greater days of receivables. The effect on the firm's cash conversion cycle and operating cycle are *most likely* a(n):

	Cash conversion cycle	Operating cycle
A)	Decrease	Increase
B)	Increase	Increase
C)	Increase	Decrease

Explanation

Greater days of receivables will increase both the cash conversion cycle and operating cycle, other things equal.

(Study Session 11, Module 37.1, LOS 37.c)

Question #21 of 44

Compared to the prior year, Chart Industries has reported that its operating cycle has remained relatively stable while its cash conversion cycle has decreased. The *most likely* explanation for this is that the firm:

A) is relying more on its suppliers for short-term liquidity.

B) is paying its bills for raw materials more rapidly.

C) has improved its inventory turnover.

Explanation

The cash conversion cycle is its operating cycle minus its average days payables outstanding. Therefore, the firm's average days payables must have increased, a clear indication that the firm is relying more heavily on credit from its suppliers. Improved inventory turnover would tend to decrease both the operating and cash conversion cycles. Relaxed credit policies would tend to increase the firm's operating cycle as receivables turnover would tend to decrease.

(Study Session 11, Module 37.1, LOS 37.c)

Question #22 of 44

Which of the following factors is *most likely* to cause a firm to need short-term financing?

A) Shorter cash conversion cycle than the industry average.

B) Operating cash inflows that fluctuate seasonally.

C) Return of principal from maturing investments.

Explanation

Firms with operating cash inflows that fluctuate seasonally are likely to experience short-term imbalances between cash inflows and cash outflows and must forecast these imbalances to manage their net daily cash positions, for example by arranging short-term borrowing over seasons when operating cash inflows are expected to be relatively low and operating cash outflows are relatively high.

(Study Session 11, Module 37.1, LOS 37.d)

Question #23 of 44

Assume that a 30-day commercial paper security has a holding period yield of 0.80%. The bond equivalent yield of this security is:

A) 10.12%.

B) 9.60%.

C) 9.73%.

Explanation

BEY = HPY × (365/days)

BEY = 0.80% × (365/30) = 9.73%

(Study Session 11, Module 37.1, LOS 37.e)

Question #24 of 44

A 91-day Treasury bill has a holding period yield of 1.5%. What is the annual yield of this T-bill on a bond-equivalent basis?

A) 6.65%.

B) 6.02%.

C) 6.24%.

Explanation

BEY = 1.5% × (365/91) = 6.02%.

(Study Session 11, Module 37.1, LOS 37.e)

Question #25 of 44

In reviewing the effectiveness of a company's working capital management, an analyst has calculated operating cycle and cash conversion cycle measures for the past three years.

	20X6	**20X7**	**20X8**
Operating cycle (number of days)	55	60	62
Cash conversion cycle (number of days)	27	30	32

The trends in the operating cycle and cash conversion cycle *most likely* indicate:

A) stretching of payables.

B) slower collections of receivables.

C) improving liquidity.

Explanation

Longer operating and cash conversion cycles are frequently signs of liquidity problems. Slower collections or inventory turnover lengthen the operating cycle. The cash conversion cycle is also growing longer, which suggests the company is not stretching payables to offset the lengthening operating cycle.

(Study Session 11, Module 37.1, LOS 37.c)

Question #26 of 44

In a recent staff meeting, David Hurley, stated that analysts should understand that financial ratios mean little by themselves. He advised his colleagues to evaluate financial ratios carefully. During the discussion he made the following statements:

Statement 1: A company can be compared with others in its industry by relating its financial ratios to industry norms. However, care must be taken because many ratios are industry-specific, but not all ratios are important to all industries.

Statement 2: Comparing a company to the overall economy is useless because overall business conditions are constantly changing. Specifically, it is not the case that financial ratios tend to improve when the economy is strong and weaken during recessionary times.

Are statements 1 and 2 as made by Hurley regarding financial ratio analysis CORRECT?

	Statement 1	Statement 2
A)	Incorrect	Correct
B)	Correct	Incorrect
C)	Correct	Correct

Explanation

Financial ratios are meaningless by themselves. To have meaning an analyst must use them with other information. An analyst should evaluate financial ratios based on industry norms and economic conditions. Statement 1 is correct. However, statement 2 is not because financial ratios tend to improve when the economy is strong and weaken when the economy is in a recession. So, financial ratios should be reviewed in light of the current stage of the business cycle.

(Study Session 11, Module 37.1, LOS 37.b)

Question #27 of 44

Which of the following forms of short-term financing is typically used to facilitate international trade?

A) Overdraft line of credit.

B) Commercial paper.

C) Banker's acceptances.

Explanation

Banker's acceptances are used by firms that export goods. A banker's acceptance is a guarantee from the bank of the firm that has ordered the goods stating that a payment will be made upon receipt of the goods. The exporting company can then sell this acceptance at a discount in order to generate immediate funds.

(Study Session 11, Module 37.1, LOS 37.g)

Question #28 of 44

An analyst is reviewing the working capital portfolio investment policy of a publicly traded firm. Which of the following components of the policy is the analyst *least likely* to find acceptable?

A) Investments in U.S. T-bills, commercial paper, and bank CDs are acceptable unless issued by Stratford Bank. ✓

B) Investments must have an A-1 rating from S&P or an equivalent rating from another agency. ✗

C) Authority for selecting and managing short-term investments rests with the firm's treasurer and any designees selected by the treasurer. ✗

Explanation

An investment policy for short-term portfolios should have the following elements: purpose, authorities, limitations/restrictions, quality, and other items. The purpose section should state the general reason the portfolio exists and the general strategy that will be followed. The limitations section generally states the types of investments that are or are not acceptable and should note only categories of securities rather than specific issuers of securities. The authorities section should state the executives who will oversee the portfolio. The quality section should state guidelines for the credit quality of the investments in the portfolio. The "other" section may be used for portfolio requirements not covered in the first four sections, such as auditing or reporting requirements.

(Study Session 11, Module 37.1, LOS 37.e)

Question #29 of 44

Liquidating short-term assets and renegotiating debt agreements are *best* described as a firm's:

A) primary sources of liquidity. ✗

B) secondary sources of liquidity. ✓

C) pulls and drags on liquidity. ✗

Explanation

Secondary sources of liquidity include liquidating short-term or long-lived assets, negotiating debt agreements (i.e., renegotiating), or filing for bankruptcy and reorganizing the company. Primary sources of liquidity are the sources of cash a company uses in its normal operations. Pulls and drags on liquidity refer to factors that weaken a company's liquidity position.

(Study Session 11, Module 37.1, LOS 37.a)

Question #30 of 44

Yields on firms' investments in short-term securities for comparison purposes are *best* stated as:

A) $\text{holding period return}\left(\frac{365}{\text{days to maturity}}\right)$.

B) $\frac{\text{discount}}{\text{face}}\left(\frac{360}{\text{days to maturity}}\right)$.

C) $\text{holding period return}\left(\frac{360}{\text{days to maturity}}\right)$.

Explanation

The yields on investments in short-term securities should be stated as bond equivalent yields (BEYs), and returns on portfolios of these securities should be stated as a weighted average of BEYs. The BEY, which is holding period yield × (365days to maturity), allows fixed-income securities whose payments are not annual to be compared with securities with annual yields.

(Study Session 11, Module 37.1, LOS 37.e)

Question #31 of 44

An appropriate cash management strategy for a company that has a seasonally high need for cash prior to the holiday shopping season would *least likely* include:

A) investing in U.S. Treasury notes at other times of the year because they are highly liquid.

B) borrowing funds though a bank line of credit.

C) allowing short-term securities to mature without reinvestment.

Explanation

Treasury notes have maturities between 2 and 10 years and, thus, have maturities longer than those of securities suitable for cash management. Allowing short-term securities to mature without reinvesting the cash generated would be one way to meet seasonal cash needs. Short-term bank borrowing or issuing commercial paper that can be paid off when holiday sales generate cash would be appropriate strategies for dealing with a predictable short-term need for cash.

(Study Session 11, Module 37.1, LOS 37.d)

Question #32 of 44

Which of the following sources of liquidity is the *most* reliable?

A) Revolving line of credit.

B) Uncommitted line of credit.

C) Committed line of credit.

Explanation

A revolving line of credit is typically for a longer term than an uncommitted or committed line of credit and thus is considered a more reliable source of liquidity. With an uncommitted line of credit, the issuing bank may refuse to lend if conditions of the firm change. An overdraft line of credit is similar to a committed line of credit agreement between banks and firms outside of the U.S. Both committed and revolving lines of credit can be verified and can be listed in the footnotes to a firm's financial statements as sources of liquidity.

(Study Session 11, Module 37.1, LOS 37.g)

Question #33 of 44

Which yield measure is the *most* appropriate for comparing a company's investments in short-term securities?

A) Bond equivalent yield.

B) Money market yield.

C) Discount basis yield.

Explanation

When evaluating the performance of its short-term securities investments, a company should compare them on a bond equivalent yield basis.

(Study Session 11, Module 37.1, LOS 37.e)

Question #34 of 44

The quick ratio is considered a more conservative measure of liquidity than the current ratio because the quick ratio excludes:

A) inventories, which are not necessarily liquid.

B) short-term marketable securities, which may need to be sold at a significant loss.

C) accounts receivable, which may not be collectible in the short term.

Explanation

The quick ratio is usually defined as (current assets – inventory) / current liabilities. It is a more restrictive measure of liquidity than the current ratio, which equals current assets / current liabilities. The numerator of the quick ratio includes cash, receivables, and short-term marketable securities.

(Study Session 11, Module 37.1, LOS 37.b)

Question #35 of 44

Which of the following is *least likely* an indicator of a firm's liquidity?

A) Amount of credit sales.

B) Cash as a percentage of sales.

C) Inventory turnover.

Explanation

No inferences about liquidity are warranted based on this measure. A firm may have higher credit sales than another simply because it has more sales overall. Cash as a proportion of sales and inventory turnover are indicators of liquidity.

(Study Session 11, Module 37.1, LOS 37.b)

Question #36 of 44

A firm has average days of receivables outstanding of 22 compared to an industry average of 29 days. An analyst would *most likely* conclude that the firm:

A) has a lower cash conversion cycle than its peer companies.

B) may have credit policies that are too strict.

C) has better credit controls than its peer companies.

Explanation

The firm's average days of receivables should be close to the industry average. A significantly lower average days receivables outstanding, compared to its peers, is an indication that the firm's credit policy may be too strict and that sales are being lost to peers because of this. We can not assume that stricter credit controls than the average for the industry are "better." We cannot conclude that credit sales are less, they may be more, but just made on stricter terms. The average days of receivables are only one component of the cash conversion cycle.

(Study Session 11, Module 37.1, LOS 37.b)

Question #37 of 44

A firm is choosing among three short-term investment securities:

Security 1: A 30-day U.S. Treasury bill with a discount yield of 3.6%.

Security 2: A 30-day banker's acceptance selling at 99.65% of face value.

Security 3: A 30-day time deposit with a bond equivalent yield of 3.65%.

Based only on these securities' yields, the firm would:

A) prefer the banker's acceptance.

B) prefer the U.S. Treasury bill.

C) prefer the time deposit.

Explanation

We can compare the yields of these securities on any single basis. The preferred basis is the bond equivalent yield.

Security 1 = discount is 3.6%(30 / 360) = 0.3%

BEY = (0.3 / 99.7) (365 / 30) = 3.661%

BEY of Security 2 = (0.35 / 99.65) × (365 / 30) = 4.273%

BEY of Security 3 = 3.65%

(Study Session 11, Module 37.1, LOS 37.e)

Question #38 of 44

A result that is *most likely* to give a financial manager concern that his firm's credit policy may have become too lenient is:

A) weighted average collection period has increased.

B) inventory turnover has decreased considerably.

C) receivables turnover has increased significantly.

Explanation

The weighted average collection period is the average number of days it takes to collect a dollar of receivables. A decreased percentage of sales made on credit or an increase in the receivables turnover ratio might result from more strict credit terms. Inventory turnover is not directly affected by credit terms, only though the effect of credit terms on overall sales.

(Study Session 11, Module 37.1, LOS 37.f)

Question #39 of 44

Alton Industries will have better liquidity than its peer group of companies if its:

A) receivables turnover is higher.

B) average trade payables are lower.

C) quick ratio is lower.

Explanation

Higher receivables turnover is an indicator of better receivables liquidity since receivables are converted to cash more rapidly. A lower quick ratio is an indication of less liquidity. Lower trade payables could be related to better liquidity, but could also be consistent with very poor liquidity and a requirement from its suppliers of cash payment.

(Study Session 11, Module 37.1, LOS 37.b)

Question #40 of 44

Which of the following *most* accurately represents the cash conversion cycle?

A) average days of receivables + average days of inventory – average days of payables.

B) average days of payables + average days of inventory – average days of receivables.

C) average days of receivables + average days of inventory + average days of payables.

Explanation

The cash conversion cycle, also called the net operating cycle is:

cash conversion cycle = (average days of receivables) + (average days of inventory) – (average days of payables)

The cash conversion cycle measures the length of time required to convert a firm's cash investment in inventory back into cash resulting from the sale of the inventory. A short cash conversion cycle is good because it indicates a relatively low investment in working capital.

(Study Session 11, Module 37.1, LOS 37.c)

Question #41 of 44

Which of the following strategies is *most likely* to be considered good payables management?

A) Taking trade discounts only if the firm's annual return on short-term investments is less than the discount percentage.

B) Paying invoices on the last day to still get the supplier's discount for early payment.

C) Paying trade invoices on the day they arrive.

Explanation

Paying invoices on the last day to get a discount (for early payment) is likely the most advantageous strategy for a firm. If the annualized percentage cost of not taking advantage of the discount is less than the firm's short-term cost of funds, it would be advantageous to pay on the due date. However, the discount percentage is not an annualized rate, so it cannot be compared directly to the firm's *annual* return on short-term investments. Paying prior to the discount cut-off date or prior to the due date sacrifices interest income for no advantage.

(Study Session 11, Module 37.1, LOS 37.f)

Question #42 of 44

An investment policy statement for a firm's short-term cash management function would *least* appropriately include:

A) information on who is allowed to invest corporate cash.

B) a list of permissible securities.

C) procedures to follow if the investment guidelines are violated.

Explanation

An investment policy statement typically begins with a statement of the purpose and objective of the investment portfolio, some general guidelines about the strategy to be employed to achieve those objectives, and the types of securities that will be used. A list of permitted securities for investment would be limited and likely too restrictive. A list of permitted security types is appropriate and can provide the necessary flexibility to increase yield within the safety and liquidity constraints appropriate for the firm.

(Study Session 11, Module 37.1, LOS 37.e)

Question #43 of 44

A company has just received a $5 million shipment from a supplier. Its terms of trade credit are 2/15 net 30. It has access to a line of credit with an annualized cost of 9%. The *best* short-term financing strategy is to pay the invoice:

A) immediately.

B) on day 30.

C) on day 15.

Explanation

The firm receives free short-term financing through day 15. It should pay with cash (or use the line of credit with an annualized cost of 9%) on day 15 to take advantage of the trade discount. Paying immediately is not the best answer because the firm incurs either a financing charge with the line of credit or lost interest on its funds if paid immediately with cash. The cost of foregoing the trade discount and paying on day 30 is $\{[1 + (0.02/0.98)]^{365/(30 - 15)}\} - 1 = 63.49\%$. This cost is much greater than the alternatives.

(Study Session 11, Module 37.1, LOS 37.f)

Question #44 of 44

Pierce Motor Company has an operating cycle of 150 days and a cash conversion cycle of 120 days, while Dunhill Motor, Inc. has an operating cycle of 140 days and a cash conversion cycle of 125 days. Based on these figures it is *most likely* that:

A) average days of payables for Dunhill is less than for Pierce.

B) average days of inventory for Dunhill is less than for Pierce.

C) average days of receivables for Dunhill is less than for Pierce.

Explanation

The operating cycle is days of inventory plus days of receivables. The cash conversion cycle is the operating cycle minus days of payables. Therefore, average days of payables are the operating cycle minus the cash conversion cycle. Dunhill's average days of payables (140 – 125 = 15) are less than Pierce's average days of payables (150 – 120 = 30). Which company has higher average days of inventory or receivables cannot be determined from the information provided.

(Study Session 11, Module 37.1, LOS 37.c)