Reading 25

WORKING CAPITAL & LIQUIDITY

1. (A) **permanent current assets using long-term funds, and fund seasonal current assets using short-term funds.**

   Explanation

   Companies with a moderate approach to working capital management typically prefer using cheaper, short-term financing to fund seasonal (variable) working capital needs, while using long-term financing to fund permanent working capital needs.

   (Module 25.1, LOS 25.c)

2. (B) **Company B**

   Explanation

   Companies with a moderate approach to working capital management typically prefer using long-term financing (like long-term debt or equity) to fund permanent working capital needs, while using short-term financing (like short-term debt) to fund variable working capital needs.

   (Module 25.1, LOS 25.c)

3. (A) **low cash conversion cycle.**

   Explanation

   High levels of prepaid sales along with low levels of inventories—typical of airlines—imply low cash conversion cycles. Low inventory levels would imply low days of inventory on hand.

   (Module 25.1, LOS 25.a)

4. (B) **double.**

   Explanation

   The CCC is calculated by adding the days of inventory on hand and the days sales outstanding, and subtracting the days payable outstanding. A doubling of all components of a positive CCC would double the value of the CCC. In fact, the doubling of all components of the CCC would double the value of any CCC (even if negative), with the exception when the CCC is zero.

   (Module 25.1, LOS 25.a)

5. (C) days of inventory on hand decreased.

Explanation

The CCC measures the time it takes for a company to convert its investments in inventory and other resources into cash inflows from sales. The CCC is calculated by adding the days of inventory on hand and the days sales outstanding, and subtracting the days payable outstanding. The CCC would, therefore, decrease if either the days of inventory on hand or the days sales outstanding decreased, or if the days payable outstanding increased.

(Module 25.1, LOS 25.a)

6. (A) The bank.

Explanation

The EAR of supplier financing = $(1 + 0.04 / 0.96)^{365/60} - 1 = 18.0\%$. The cost of implicit supplier financing is much higher than the cost of explicit bank financing of 6.5%.

(Module 25.1, LOS 25.a)

7. (B) The CCC would increase by 10 days.

Explanation

The CCC is calculated by adding the days of inventory on hand and the days sales outstanding, and subtracting the days payable outstanding. A shorter days payable outstanding implies less generous credit terms by suppliers, where the company must pay its suppliers in a shorter time period. This would increase the CCC by 10 days.

(Module 25.1, LOS 25.a)

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8. (A) inventories.

Explanation

The quick ratio is usually defined as (current assets – inventories) / current liabilities. The quick ratio excludes inventories from current assets because inventories are not necessarily liquid. It is a more restrictive measure of liquidity than the current ratio, which equals current assets / current liabilities. Current assets that remain in the numerator of the quick ratio include cash and cash equivalents, accounts receivable, and short-term marketable securities.

(Module 25.1, LOS 25.b)

9. (B) The company's trade creditors have tightened their credit conditions.

Explanation

An increasing CCC would signify a less efficient use of working capital. This could result from any of the following changes: (1) slower inventory turnover, (2) a slower collection of accounts receivable (meaning the company is less strict in its credit terms with its customers), and (3) a shorter payable period (meaning the company's trade creditors have tightened their credit terms and conditions and require faster repayment).

(Module 25.1, LOS 25.a)

10. (C) **A company funds its inventory needs using long-term debt.**

Explanation

Companies with a conservative approach to working capital management typically finance working capital needs using long-term financing, including both equity and debt issuances. For example, they tend to use long-term funds to pay for permanent working capital like inventory, salaries, and rent. These companies typically hold higher levels of short-term assets compared to long-term assets.

(Module 25.1, LOS 25.c)

11. (A) **too high.**

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.

(Module 25.1, LOS 25.a)

12. (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:

$$\text{Cash Conversion cycle} = \begin{pmatrix}\text{average days} \\ \text{of receivables}\end{pmatrix} + \begin{pmatrix}\text{average days} \\ \text{Of Inventary}\end{pmatrix} - \begin{pmatrix}\text{average days} \\ \text{of Payable}\end{pmatrix}$$

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.

(Module 25.1, LOS 25.a)

13. (A) **A company finances working capital using short-term funds.**

Explanation

Companies with an aggressive approach to working capital management favour using cheaper, short-term financing to fund their working capital needs.

(Module 25.1, LOS 25.c)

14. (B) **costs.**

Explanation

The management's decision to use more long-term financing to fund working capital (like inventory costs and rent expense) is indicative of a more conservative approach to working capital management. The conservative approach typically results in higher funding costs (long-term debt costs are higher than short-term) and lower profitability— and therefore, equity.

(Module 25.1, LOS 25.c)