Question #1 of 15

Question ID: 1463581

An example of a primary source of liquidity is:

A) using trade credit from vendors.

B) renegotiating debt agreements.

C) filing for bankruptcy.

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 best described as secondary sources of liquidity because they are sources to which a firm resorts when in financial distress.

(Module 32.1, LOS 32.c)

Question #2 of 15

Question ID: 1463585

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) may have credit policies that are too strict.

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

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 cannot 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.

(Module 32.1, LOS 32.d)

Question #3 of 15

Question ID: 1463584

A company has better liquidity than its peer group if its:

A) quick ratio is lower.

B) average trade payables are lower.

C) receivables turnover is higher.

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.

(Module 32.1, LOS 32.d)

Question #4 of 15

Question ID: 1463580

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) drag on liquidity.

C) liquidity premium.

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.

(Module 32.1, LOS 32.c)

Question #5 of 15

Question ID: 1463586

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

A) inventories.

B) marketable securities.

C) accounts receivable.

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 32.1, LOS 32.d)

Question #6 of 15

Question ID: 1463577

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

A) Revolving line of credit.

B) Committed line of credit.

C) Uncommitted 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.

(Module 32.1, LOS 32.a)

Question #7 of 15

Question ID: 1463574

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

A) issuing commercial paper.

B) factoring its receivables.

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

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.

(Module 32.1, LOS 32.a)

Question #8 of 15

Question ID: 1463576

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) Factoring agreement.

C) Uncommitted line of credit.

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.

(Module 32.1, LOS 32.a)

Question #9 of 15

Question ID: 1463578

A bank offers a corporation a line of credit for a certain amount but reserves the right to refuse to honor any request for the use of the line. This arrangement is *best* described as:

A) a regular line of credit.

B) a revolving line of credit.

C) an uncommitted line of credit.

Explanation

With an uncommitted line of credit, a bank extends an offer of credit for a certain amount but may refuse to lend if circumstances change. With a regular or committed line of credit, a bank extends an offer of credit that it commits to for a given time period. A revolving line of credit allows companies to borrow and repay funds as their needs change over time.

(Module 32.1, LOS 32.a)

Question #10 of 15

Question ID: 1463587

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

A) Inventory turnover.

B) Amount of credit sales.

C) Cash as a percentage of sales.

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.

(Module 32.1, LOS 32.d)

Question #11 of 15

Question ID: 1463582

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

A) primary sources of liquidity.

B) pulls and drags on liquidity.

C) secondary sources of 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.

(Module 32.1, LOS 32.c)

Question #12 of 15

Question ID: 1463583

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	2.3	1.8
Net Profit Margin	22%	24%
Return on Equity	17%	20%
Total Debt / Total Capital	35%	56%
Interest Coverage Ratio	4.7	4.1

Based on the above data, which of the following can the analyst conclude? Compared to its competitors, Iridescent Carpeting is more:

A) leveraged.

B) liquid.

C) profitable.

Explanation

Based on the data provided, 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. 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 ratio.

(Module 32.1, LOS 32.d)

Question #13 of 15

Question ID: 1463575

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

A) Revolving line of credit.

B) Uncommitted line of credit.

C) Committed 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.

(Module 32.1, LOS 32.a)

Question #14 of 15

Question ID: 1463579

An example of a secondary source of liquidity is:

A) negotiating debt contracts. ✓

B) cash flow management. ✗

C) trade credit and bank lines of credit. ✗

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.

(Module 32.1, LOS 32.c)

Question #15 of 15

Question ID: 1463596

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

A) Return of principal from maturing investments. ✗

B) Operating cash inflows that fluctuate seasonally. ✓

C) Shorter cash conversion cycle than the industry average. ✗

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.

(Module 32.1, LOS 32.e)