Chapter 14
Working Capital and Current Assets Management

■ Learning Goals

1. Understand short-term financial management, net working capital, and the related tradeoff between profitability and risk.
2. Describe the cash conversion cycle, its funding requirements, and the key strategies for managing it.
3. Discuss inventory management: differing views, common techniques, and international concerns.
4. Explain the credit selection process and the quantitative procedure for evaluating changes in credit standards.
5. Review the procedures for quantitatively considering cash discount changes, other aspects of credit terms, and credit monitoring.
6. Understand the management of receipts and disbursements, including floats, speeding collections, slowing payments, cash concentration, zero-balance accounts, and investing in marketable securities.

■ True/False

1. A firm that is unable to pay its bills as they come due is technically insolvent.

   Answer: TRUE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Basics of Short-Term Financial Management

2. The short-term financial management is concerned with management of the firm's current assets and current liabilities.

   Answer: TRUE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Basics of Short-Term Financial Management

3. In the short-term financial management, the goal is to manage each of the firm's current assets and current liabilities in order to achieve a balance between profitability and risk that contributes to the firm's value.

   Answer: TRUE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Basics of Short-Term Financial Management

4. Working capital represents the portion of the firm's investment that circulates from one form to another in the long-term conduct of business.

   Answer: FALSE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Working Capital Management

5. In general, the more a firm's current assets cover its short-term obligations, the better able it will be to pay its bills as they come due.

   Answer: TRUE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Working Capital Management

6. The more predictable its cash inflows, the more net working capital a firm needs.

   Answer: FALSE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Working Capital Management

7. As the ratio of current assets to total assets increases, the firm's risk increases.

   Answer: FALSE
   Level of Difficulty: 2
   Learning Goal: 1
   Topic: Working Capital Management

8. Because firms are unable to match cash inflows to outflows with certainty, most of them need current liabilities that more than cover outflows for current assets.

   Answer: FALSE
   Level of Difficulty: 2
   Learning Goal: 1
   Topic: Working Capital Management

9. Too much investment in current assets reduces profitability, whereas too little investment increases the risk of not being able to pay debts as they come due.

   Answer: TRUE
   Level of Difficulty: 2
   Learning Goal: 1
   Topic: Tradeoff Between Profitability and Risk

10. Too little current liability financing reduces profitability, whereas too much of this financing increases the risk of not being able to pay debts as they come due.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Tradeoff Between Profitability and Risk

11. Business risk is the risk of being unable to make the scheduled fixed payments associated with debt, leases, and preferred stock financing as they come due.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Business Risk

12. The cash inflows—that is, the conversion of the current assets to more liquid forms—are relatively predictable but the cash outlays for current liabilities are difficult to predict.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Working Capital Management

13. Net working capital can be defined as the portion of the firm's current assets financed with long-term funds.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Net Working Capital

14. A firm is said to be technically insolvent when its total assets is less than its total liabilities and stockholders' equity.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Technical Insolvency

15. An increase in current assets increases net working capital, thereby reducing the risk of technical insolvency.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 1
    Topic: Technical Insolvency

16. The effect of a decrease in the ratio of current assets to total assets and the effect of an increase in the ratio of current liabilities to total assets are increases in the firm's profits and, correspondingly, its risk.

    Answer: TRUE
    Level of Difficulty: 4
    Learning Goal: 1
    Topic: Tradeoff Between Profitability and Risk

17. The cash conversion cycle is the amount of time that elapses from the point when the firm inputs materials and labor into the production process to the point when cash is collected from the sale of the resulting finished product.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Cash Conversion Cycle

18. The firm's operating cycle (OC) is simply the sum of the average age of inventory (AAI) and the average payment period (APP).

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Operating Cycle

19. The cash conversion cycle is the total number of days in the operating cycle less the average payment period for inputs to production.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Cash Conversion Cycle

20. A negative cash conversion cycle (CCC) means the average payment period (APP) exceeds the operating cycle (OC).

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Cash Conversion Cycle

21. The operating cycle is the recurring transition of a firm's working capital from cash to inventories and inventories to receivables and back to cash.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Operating Cycle

22. The aggressive financing strategy is a strategy by which the firm finances its current assets with short-term funds and its fixed assets with long-term funds.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Aggressive Financing Strategy

23. The permanent financial need of a firm is the financing requirements for the firm's fixed assets plus the permanent portion of the firm's current assets.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Permanent Funding Requirements

24. The conservative financing strategy is a strategy by which the firm finances at least its seasonal requirements, and possibly some of its permanent requirements, with short-term funds and the balance of its permanent requirements with long-term funds.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Conservative Financing Strategy

25. The aggressive strategy operates with minimum net working capital since only the permanent portion of the firm's current assets is being financed with long-term funds.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Aggressive Financing Strategy

26. Operating cycle is the amount of time the firm's cash is tied up between payment for production inputs and receipt of payment from the sale of the resulting finished product.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Operating Cycle

27. By efficiently managing the firm's operating and cash conversion cycles, the financial manager can maintain a high level of cash investment and thereby contribute toward maximization of share value.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Operating and Cash Conversion Cycles

28. The ability to purchase production inputs on credit allows the firm to partially (or may be even totally) offset the length of time resources are tied up in the operating cycle.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Operating Cycle

29. The cash conversion cycle is the difference between the number of days resources are tied up in the operating cycle and the average number of days the firm can delay making payment on the production inputs purchased on credit.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Cash Conversion Cycle

30. A positive cash conversion cycle means that the firm must obtain financing to support the cash conversion cycle.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Cash Conversion Cycle

31. When a firm's cash conversion cycle is negative, the firm should benefit by being able to use the financing provided by the suppliers of its production inputs to help support aspects of the business other than just the operating cycle.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Cash Conversion Cycle

32. Nonmanufacturing firms are more likely to have positive cash conversion cycles; they generally carry smaller, faster-moving inventories and often sell their products for cash.

    Answer: FALSE
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Cash Conversion Cycle

33. When implementing the cash management strategies, a firm should take care to avoid having a large number of inventory stockouts, to avoid losing the use of its cash by collecting its accounts receivable using high-pressure collection techniques, and to avoid damaging the firm's credit rating by overstretching accounts payable.

    Answer: FALSE
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Cash Conversion Cycle Management Strategies

34. One aspect of risk associated with the aggressive strategy's maximum use of short-term financing is the fact that changing short-term interest rates can result in significantly higher borrowing costs as the short-term debt is refinanced.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Aggressive Financing Strategy

35. The aggressive financing strategy is a strategy by which the firm finances all projected funds requirements with long-term funds and uses short-term financing only for emergencies or unexpected outflows.

    Answer: FALSE
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Aggressive Financing Strategy

36. The aggressive financing strategy is risky due to its minimum level of net working capital, high dependency on short-term sources of funds, and the changing short-term interest.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Aggressive Financing Strategy

37. Under conservative financing strategy, short-term financing is used only to finance an emergency, an unexpected outflow of funds, and the variable portion of the firm's current assets.

    Answer: FALSE
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Conservative Financing Strategy

38. The risk of the conservative financing requirements is low because of its high level of net working capital, and the fact that the strategy does not require the firm to use any of its limited short-term borrowing capacity.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Conservative Financing Strategy

39. The conservative strategy is less profitable than the aggressive approach because it requires the firm to pay interest on unneeded funds.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Conservative Financing Strategy

40. The ABC system is an inventory management technique for determining the optimal order quantity for an item of inventory.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 3
    Topic: ABC Inventory System

41. The reorder point is the point at which the firm receives orders.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 3
    Topic: Inventory Reorder Point

42. Safety stocks are extra inventories that can be drawn down when actual lead times and/or usage rates are greater than expected.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 3
    Topic: Inventory Safety Stock

43. In the ABC system of inventory management, the red-line method or system could be utilized to control C items.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 3
    Topic: ABC Inventory System

44. In EOQ model, the average inventory is defined as the order quantity divided by 2.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 3
    Topic: EOQ Inventory Model

45. The economic order quantity (EOQ) is the order quantity which minimizes the carrying costs per unit per period.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: EOQ Inventory Model

46. In the economic order quantity model, if carrying costs increase while all other costs remain unchanged, the number of orders placed would be expected to increase.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: EOQ Inventory Model

47. In the EOQ model, the total cost is minimized at the point where the order costs and carrying costs are equal.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: EOQ Inventory Model

48. The reorder point is an inventory management system that compares production needs to available inventory balances and determines when orders should be placed for various items on the firm's bill of materials.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: Inventory Reorder Point

49. Since its objective is to minimize inventory investment, a Just-in-Time (JIT) system uses no, or very little, safety stocks.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Just In Time Inventory Management System

50. Because managing inventory is just like managing any other investment, decisions about the level of inventory should be guided by the effect of inventory levels on sales.

    Answer: FALSE
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Basics of Inventory Management

51. A firm's credit policy generally includes determining credit selection, credit terms, and collection.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Credit Policy Basics

52. A firm's credit selection is the process of determining the minimum requirements for extending credit to a customer.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Credit Selection Standards

53. Credit analysts usually analyze an applicant's creditworthiness by using the dimensions of credit such as character, capacity, capital, collateral, and conditions.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Five C's of Credit

54. A firm's credit terms specify the minimum requirements for extending credit to a customer.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Credit Selection Standards

55. The firm's credit standards are the minimum requirements for extending credit to a customer.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Credit Selection Standards

56. The average investment in accounts receivable is equal to the firm's total variable cost of annual sales divided by its average collection period.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Investment in Accounts Receivable

57. In international trade when a U.S. company sells a product in France, the U.S. company experiences an exchange rate gain if the franc depreciates against the dollar before the U.S. exporter collects on its accounts receivable.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 4
    Topic: Managing International Credit

58. In analyzing an applicant's creditworthiness, the credit manager typically gives primary attention to two of the five C's of credit—collateral and condition—since they represent the most basic requirements for extending credit to an applicant.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 4
Topic: Five C's of Credit

59. One of the key inputs to the final credit decision is the credit analyst's subjective judgment of a firm's creditworthiness since it can provide a better feel of a firm's operation than any quantitative figures.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 4
Topic: Credit Selection Standards

60. The firm's credit selection procedures must be established on a sound economic basis that considers the costs of investigating the creditworthiness of a customer and the expected size of its credit purchases.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 4
Topic: Credit Selection Standards

61. A firm's credit standard is a procedure for ranking of an applicant's overall credit strength, derived as a weighted average of scores on key financial and credit characteristics.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 4
Topic: Credit Selection Standards

62. As credit standards are relaxed, sales are expected to increase and the investment in accounts receivable is expected to decrease.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 4
Topic: Investment in Accounts Receivable

63. The turnover of accounts receivable can be calculated by dividing annual sales by accounts receivable.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 4
Topic: Investment in Accounts Receivable

64. Increasing the length of the credit period should increase sales, but both the investment in accounts receivable and bad debt expenses are likely to increase as well.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 4
Topic: Relaxing Credit Standards

65. If the firm relaxes its credit standards, the volume of accounts receivable increases and so does the firm's carrying cost.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 4
    Topic: Relaxing Credit Standards

66. A relaxation of credit standards is expected to affect profits positively due to lower carrying costs whereas tightening credit standards would affect profits negatively as a result of higher carrying costs.

    Answer: FALSE
    Level of Difficulty: 3
    Learning Goal: 4
    Topic: Relaxing Credit Standards

67. The increase in bad debts associated with tightening credit standards raises bad debt expenses and has a negative impact on profits.

    Answer: FALSE
    Level of Difficulty: 3
    Learning Goal: 4
    Topic: Tightening Credit Standards

68. The cost of marginal investment in accounts receivable can be calculated by finding the difference between the average investment in accounts receivable before and after the introduction of the changes in credit standards.

    Answer: FALSE
    Level of Difficulty: 3
    Learning Goal: 4
    Topic: Investment in Accounts Receivable

69. The cost of marginal bad debts is found by multiplying the firm's opportunity cost by the difference between the level of bad debts before and after the relaxation of credit standards.

    Answer: FALSE
    Level of Difficulty: 3
    Learning Goal: 4
    Topic: Relaxing Credit Standards

70. If the level of bad debt attributable to credit policy is relatively constant, increasing collection expenditures can be expected to reduce bad debts.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 5
    Topic: Changing Credit Standards

71. 2/15 net 45 translates as 2 percent of the balance is due in 15 days; the remaining balance is due in 45 days.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 5
    Topic: Understanding Credit Terms

72. If the cash discount period is increased, the firm's investment in accounts receivable due to non-discount takers now paying earlier is expected to decrease.

Answer: TRUE
Level of Difficulty: 3
Learning Goal: 5
Topic: Increasing the Cash Discount Period

73. If the cash discount period is increased, the firm's investment in accounts receivable due to discount takers still getting cash discounts but paying later is expected to increase.

Answer: TRUE
Level of Difficulty: 3
Learning Goal: 5
Topic: Increasing the Cash Discount Period

74. If the firm's credit period in decreased, the sales volume can be expected to increase, the investment in accounts receivable can be expected to increase, and the bad debt expenses can be expected to increase.

Answer: FALSE
Level of Difficulty: 3
Learning Goal: 5
Topic: Decreasing the Cash Discount Period

75. When a firm initiates or increases a cash discount, the net effect on the accounts receivable investment is difficult to determine because the nondiscount takers paying earlier will reduce the accounts receivable investment, while the new customer accounts will increase this investment.

Answer: TRUE
Level of Difficulty: 3
Learning Goal: 5
Topic: Increasing the Cash Discount Period

76. The net effect of changes in the cash discount period is quite difficult to analyze because they are directly attributable to the three forces affecting the firm's investment in accounts receivable.

Answer: TRUE
Level of Difficulty: 3
Learning Goal: 5
Topic: Changing the Cash Discount Period

77. An increase in accounts receivable turnover due to an increase in collection efforts will decrease the firm's marginal investment in accounts receivable.

Answer: TRUE
Level of Difficulty: 3
Learning Goal: 5
Topic: Increasing Collection Efforts

78. A decrease in collection efforts will result in an increase in sales volume, an increase in the investment in accounts receivable, an increase in bad debt expenses, and a decrease in collection expenditures.

Answer: TRUE
Level of Difficulty: 3
Learning Goal: 5
Topic: Decreasing Collection Efforts

79. Increased collection expenditures should reduce the investment in accounts receivable and bad debt expenses, increasing profits.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 5
    Topic: Increasing Collection Efforts

80. By increasing collection expenditures, the firm can decrease bad debt losses up to a point, beyond which bad debts can not be economically reduced. These inescapable bad debts are attributed to the firm's credit policy.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 5
    Topic: Increasing Collection Efforts

81. Processing float is the delay between the receipt of a check by the payee and its deposit in the firm's account.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 6
    Topic: Processing Float

82. Mail float is the delay between the deposit of a check by a payee and the actual availability of the funds.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 6
    Topic: Mail Float

83. Assuming that the firm has done all it can to stimulate customers to pay promptly and to select vendors offering the most attractive and flexible credit terms, it can further speed collections and slow disbursements by taking advantage of the "float" existing in the collection and payment systems.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 6
    Topic: Managing Float

84. Float exists when a payee has received funds in a spendable form but these funds have not been withdrawn from the account of the payer.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 6
    Topic: Managing Float

85. Collection float is experienced by the payer and is a delay in the receipt of funds.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 6
    Topic: Collection Float

86. Disbursement float is experienced by the payee and is a delay in the actual withdrawal of funds.

Answer: FALSE
Level of Difficulty: 1
Learning Goal: 6
Topic: Disbursement Float

87. Collection float results from the lapse between the time that a firm deducts a payment from its checking account ledger and the time that funds are actually withdrawn from its accounts.

Answer: FALSE
Level of Difficulty: 1
Learning Goal: 6
Topic: Collection Float

88. Disbursement float results from the delay between the time that a payer or customer deducts a payment from its checking account ledger (disburses it) and the time that the payee or vendor actually receives these funds in a spendable form.

Answer: FALSE
Level of Difficulty: 1
Learning Goal: 6
Topic: Disbursement Float

89. Controlled disbursing involves the strategic use of mailing points and bank accounts to lengthen mail float and clearing float, respectively.

Answer: TRUE
Level of Difficulty: 1
Learning Goal: 6
Topic: Controlled Disbursing

90. Lockbox system is used to reduce collection float by shortening all three basic float components (i.e., mail, processing, and clearing).

Answer: TRUE
Level of Difficulty: 1
Learning Goal: 6
Topic: Lockbox System

91. The ACH (automated clearing house) debits are preauthorized electronic withdrawals from the payer's account.

Answer: TRUE
Level of Difficulty: 1
Learning Goal: 6
Topic: Automated Clearing House

92. Controlled disbursing is a method of consciously anticipating the mail, processing, and clearing time involved with the payment process.

Answer: FALSE
Level of Difficulty: 1
Learning Goal: 6
Topic: Controlled Disbursing

93. Federal agency issues are low-risk securities issued by government agencies but not guaranteed by the U.S. Treasury.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 6
    Topic: Federal Agency Issues

94. Eurodollar deposits are deposits of currency that are not native to the country in which the bank is located.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 6
    Topic: Eurodollar Deposits

95. To be truly marketable, a security must have three basic characteristics: a ready market, risk-free, and safety of principal.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 6
    Topic: Marketable Securities

96. The market for a security should have both breadth and depth in order to minimize the amount of time required to convert it into cash.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 6
    Topic: Marketable Securities

97. Since Treasury bills are issued in bearer form, they are considered to be virtually risk-free.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 6
    Topic: Treasury Bills

98. The yields on Treasury bills are generally higher than those on any other marketable securities due to their virtually risk-free nature.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 6
    Topic: Treasury Bills

99. Federal agency issues are obligations of the U.S. Treasury and are readily accepted as low-risk securities.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 6
    Topic: Federal Agency Issues

100. Commercial paper is a short-term fund on deposit at commercial banks having variable yields based on size, maturity, and prevailing money market conditions.

Answer: FALSE
Level of Difficulty: 1
Learning Goal: 6
Topic: Commercial Paper

101. Cash management techniques are aimed at minimizing the firm's financing requirements by taking advantage of certain imperfections in the collection and payment system.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 6
Topic: Cash Management Techniques

102. The entire process resulting from a check issue and mail by the payer company to the payee company (i.e., mail float, processing float, and clearing float) is disbursement float to the payer company and is collection float to the payee company.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 6
Topic: Managing Float

103. Playing the float involves the strategic use of mailing points and bank accounts to lengthen mail float and clearing float, respectively.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 6
Topic: Managing Float

104. With the ACH (automated clearing house) credits, disbursement float is sacrificed because ACH transactions immediately draw down the company's payroll account on pay day.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 6
Topic: Automated Clearing House

105. Zero-balance accounts are checking accounts in which a zero balance is maintained and the bank automatically covers all checks presented against the accounts.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 6
Topic: Zero Balance Accounts

106. A major decision confronting the business firm when purchasing marketable securities involves a trade-off between the opportunity to earn a return on idle funds during the holding period and the brokerage costs associated with the purchase and sale of marketable securities.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 6
Topic: Marketable Securities

107. Treasury notes are obligations of the U.S. Treasury that are issued weekly on an auction basis and have common maturities of 91 and 182 days. Due to the existence of a strong secondary market, these notes are quite attractive marketable security investments.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 6
Topic: Treasury Notes

108. Most federal agency issues have short maturities and offer slightly higher yields than U.S. Treasury issues having similar maturities.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 6
Topic: Federal Agency Issues

109. The yields on negotiable certificates of deposit are typically above those on U.S. Treasury issues and comparable to the yields on commercial paper with similar maturities.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 6
Topic: Negotiable CDs

110. A banker's acceptance is a low-risk security because at least two, and sometimes three, parties may be liable for its payment at maturity.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 6
Topic: Banker's Acceptances

111. In exchange for the tailor-made maturity date provided by the repurchase agreement, the bank or security dealer provides a return slightly below that obtainable through outright purchase of similar marketable securities.

Answer: TRUE
Level of Difficulty: 3
Learning Goal: 6
Topic: Repurchase Agreements

112. The higher yields on Eurodollar deposits compared with nearly all other marketable securities, governmental or nongovernmental, with similar maturities are attributable to (1) the fact that the depository banks are generally less closely regulated than U.S. banks and are therefore more risky, and (2) some foreign exchange risk may be present.

Answer: TRUE
Level of Difficulty: 4
Learning Goal: 6
Topic: Eurodollar Deposits

113. A popular extension of materials requirement planning is manufacturing resource planning II, which integrates data from numerous areas such as finance, accounting, marketing, engineering, and manufacturing using a sophisticated computer system.

Answer: TRUE
Level of Difficulty: 3
Learning Goal: 3
Topic: Manufacturing Resource Planning

114. A popular extension of materials requirement planning is inventory integration automation II, which integrates data from numerous areas such as finance, accounting, marketing, engineering, and manufacturing using a sophisticated computer system.

Answer: FALSE
Level of Difficulty: 3
Learning Goal: 3
Topic: Manufacturing Resource Planning

115. An aging schedule breaks down accounts receivable into groups on the basis of the first letter of the name of the company that owes on the account.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 6
Topic: Accounts Receivable Aging Schedule

■ Multiple Choice Questions

1. Net working capital is defined as

(a) a ratio measure of liquidity best used in cross-sectional analysis.
(b) the portion of the firm's assets financed with short-term funds.
(c) current liabilities minus current assets.
(d) current assets minus current liabilities.

Answer: D
Level of Difficulty: 1
Learning Goal: 1
Topic: Net Working Capital

2. The portion of a firm's current assets financed with long-term funds may be called

(a) working capital.
(b) accounts receivable.
(c) net working capital.
(d) inventory.

Answer: C
Level of Difficulty: 1
Learning Goal: 1
Topic: Net Working Capital

3. In working capital management, risk is measured by the probability that a firm will become
   (a) liquid.
   (b) technically insolvent.
   (c) unable to meet long-term obligations.
   (d) less profitable.

   Answer: B
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Working Capital Management

4. The conversion of current assets from inventory to receivables to cash provides the _________ of cash used to pay the current liabilities, which represents a(n) _________ of cash.
   (a) outflow; inflow
   (b) use; source
   (c) source; use
   (d) inflow; outflow

   Answer: C
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Working Capital Management

5. The goal of working capital management is to
   (a) balance current assets against current liabilities.
   (b) pay off short-term debts.
   (c) achieve a balance between risk and return in order to maximize the firm's value.
   (d) achieve a balance between short-term and long-term assets so that they add to the achievement of the firm's overall goals.

   Answer: C
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Working Capital Management

6. Current liabilities can be viewed as
   (a) debts due in one year.
   (b) debts due in less than a year.
   (c) sources of cash inflows.
   (d) sources of cash outflows.

   Answer: D
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Working Capital Management

7. The most difficult set of accounts to predict are
   (a) current assets.
   (b) current liabilities.
   (c) fixed assets.
   (d) long-term debt.

   Answer: A
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Working Capital Management

8. Current liabilities are
   (a) easy to obtain.
   (b) lower in cost than long-term liabilities.
   (c) tied to the level of fixed assets.
   (d) a function of collection policy.

   Answer: B
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Working Capital Management

9. In general, the more working capital a firm has,
   (a) the greater its risk.
   (b) the lower its risk.
   (c) the less likely are creditors to lend to the firm.
   (d) the lower its level of long-term funds.

   Answer: B
   Level of Difficulty: 2
   Learning Goal: 1
   Topic: Working Capital Management

10. A(n) _________ in current assets _________ net working capital, thereby _________ the risk of technical insolvency.
   (a) decrease; increases; increasing
   (b) increase; decreases; increasing
   (c) increase; increases; reducing
   (d) decrease; decreases; reducing

   Answer: C
   Level of Difficulty: 3
   Learning Goal: 1
   Topic: Working Capital Management

11. A(n) _________ in current liabilities _________ net working capital, thereby _________ the risk of technical insolvency.
    (a) decrease; increases; increasing
    (b) increase; decreases; increasing
    (c) increase; increases; reducing
    (d) decrease; decreases; reducing

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 1
    Topic: Working Capital Management

12. When a portion of the firm's fixed assets are financed with current liabilities, the firm
    (a) has positive net working capital.
    (b) has negative net working capital.
    (c) has excessive amounts of current assets.
    (d) is in a low-risk position.

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 1
    Topic: Working Capital Management

13. The purpose of managing current assets and current liabilities is to
    (a) achieve as low a level of current assets as possible.
    (b) achieve as low a level of current liabilities as possible.
    (c) achieve a balance between profitability and risk that contributes to the firm's value.
    (d) achieve as high a level of current liabilities as possible.

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 1
    Topic: Tradeoff between Profitability and Risk

14. Relative to cash flows affecting net working capital, all of the following are true EXCEPT
    (a) cash inflows are generally more predictable than cash outlays.
    (b) cash outlays for current liabilities are relatively predictable.
    (c) the more predictable the cash inflows, the less net working capital a firm needs.
    (d) because most firms are unable to match cash inflows to outflows with certainty, current assets that more than cover outflows for current liabilities are necessary.

    Answer: A
    Level of Difficulty: 3
    Learning Goal: 1
    Topic: Working Capital Management

15. The firm's permanent financing requirement is financed with _________ in the aggressive financing strategy.
(a) long-term sources
(b) short-term sources
(c) retained earnings
(d) accounts payable

Answer: A
Level of Difficulty: 1
Learning Goal: 2
Topic: Permanent Funding Requirements

16. Most firms employ _________ financing strategy.
(a) an aggressive
(b) a conservative
(c) a trade-off
(d) a seasonal

Answer: C
Level of Difficulty: 1
Learning Goal: 2
Topic: Trade-off Financing Strategy

17. The firm's financing requirements can be separated into
(a) current liabilities and long-term funds.
(b) current assets and fixed assets.
(c) current liabilities and long-term debt.
(d) seasonal and permanent.

Answer: D
Level of Difficulty: 1
Learning Goal: 2
Topic: Permanent and Seasonal Funding Requirements

18. The basic strategies for determining the appropriate financing mix are
(a) seasonal and permanent.
(b) short-term and long-term.
(c) aggressive and conservative.
(d) current and fixed.

Answer: C
Level of Difficulty: 1
Learning Goal: 2
Topic: Aggressive versus Conservative Financing Strategy

19. If a firm uses an aggressive financing strategy,
    (a) it increases return and increases risk.
    (b) it increases return and decreases risk.
    (c) it decreases return and increases risk.
    (d) it decreases return and decreases risk.

    Answer: A
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Aggressive Financing Strategy

20. One major risk a firm assumes in an aggressive financing strategy is
    (a) the possibility that collections will be slower than expected.
    (b) the possibility that long-term funds may not be available when needed.
    (c) the possibility that short-term funds may not be available when needed.
    (d) the possibility that it will run out of cash.

    Answer: C
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Aggressive Financing Strategy

21. The _________ is the time period that elapses from the point when the firm makes the outlay to purchase raw materials on account to the point when payment is made to the supplier of the goods.
    (a) cash conversion cycle
    (b) average payment period
    (c) average age of inventory
    (d) average collection period

    Answer: B
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Average Payment Period

22. When managing inventories, a good strategy is to increase inventory turnover by doing the following EXCEPT
    (a) increase raw materials turnover.
    (b) shorten the production cycle.
    (c) produce low-cost short cycle goods.
    (d) increase finished goods turnover.

    Answer: C
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Inventory Turnover

23. The basic strategies that should be employed by the business firm in managing cash include all of the following EXCEPT
    (a) paying accounts payable as late as possible without damaging the firm's credit rating.
    (b) turning over inventory as quickly as possible, avoiding stockouts.
    (c) operating in a fashion that requires maximum cash.
    (d) collecting accounts receivable as quickly as possible without damaging customer rapport.

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Managing the Cash Conversion Cycle

24. The _________ of a firm is the amount of time that elapses from the point when the firm makes an outlay to purchase raw materials to the point when cash is collected from the sale of the finished good.
    (a) cash turnover
    (b) cash conversion cycle
    (c) average age of inventory
    (d) average collection period

    Answer: B
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Cash Conversion Cycle

25. The _________ of a firm is the amount of time that elapses from the point when the firm inputs material and labor into the production process to the point when cash is collected from the sale of the finished product that contains these production inputs.
    (a) cash conversion cycle
    (b) average age of inventory
    (c) operating cycle
    (d) average collection period

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Operating Cycle

26. A firm has an average age of inventory of 90 days, an average collection period of 40 days, and an average payment period of 30 days. The firm's operating cycle is _________ days.
    (a) 110
    (b) 130
    (c) 120
    (d) 70

    Answer: B
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Operating Cycle (Equation 14.1)

27. A firm has an operating cycle of 120 days, an average collection period of 40 days, and an average payment period of 30 days. The firm's average age of inventory is _________ days.
    (a) 80
    (b) 50
    (c) 90
    (d) 70

    Answer: A
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Average Age of Inventory (Equation 14.1)

28. A firm has a cash conversion cycle of 80 days, an average collection period of 25 days, and an average age of inventory of 70 days. Its operating cycle is _________ days.
    (a) 95
    (b) 105
    (c) 60
    (d) 130

    Answer: A
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Operating Cycle (Equation 14.1)

29. A firm has an average age of inventory of 60 days, an average collection period of 45 days, and an average payment period of 30 days. The firm's cash conversion cycle is _________ days.
    (a) 15
    (b) 45
    (c) 75
    (d) 135

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Cash Conversion Cycle (Equation 14.2 and Equation 14.3)

30. A firm has a cash conversion cycle of 120 days, an average collection period of 25 days, and an average payment period of 50 days. The firm's average age of inventory is _________ days.
    (a) 45
    (b) 95
    (c) 125
    (d) 145

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Average Age of Inventory (Equation 14.2 and Equation 14.3)

31. A firm purchased raw materials on account and paid for them within 30 days. The raw materials were used in manufacturing a finished good sold on account 100 days after the raw materials were purchased. The customer paid for the finished good 60 days later. The firm's cash conversion cycle is _________ days.

(a) 10
(b) 70
(c) 130
(d) 190

Answer: C
Level of Difficulty: 2
Learning Goal: 2
Topic: Cash Conversion Cycle (Equation 14.2 and Equation 14.3)

32. The _________ is the time period that elapses from the point when the firm uses the raw materials in manufacturing a finished good to the point when the finished good is sold.

(a) cash turnover
(b) cash conversion cycle
(c) average age of inventory
(d) average collection period

Answer: C
Level of Difficulty: 2
Learning Goal: 2
Topic: Average Age of Inventory

33. The _________ is the time period that elapses from the point when the firm sells a finished good on account to the point when the receivable is collected.

(a) cash conversion cycle
(b) average payment period
(c) average age of inventory
(d) average collection period

Answer: D
Level of Difficulty: 2
Learning Goal: 2
Topic: Average Collection Period

34. A firm has an average age of inventory of 101 days, an average collection period of 49 days, and an average payment period of 60 days. The firm's cash conversion cycle is

(a) 150 days.
(b) 90 days.
(c) 112 days.
(d) 8 days.

Answer: B
Level of Difficulty: 2
Learning Goal: 2
Topic: Cash Conversion Cycle (Equation 14.2 and Equation 14.3)

35. A firm can reduce its cash conversion cycle by
    (a) increasing the average age of inventory.
    (b) increasing the average collection period.
    (c) decreasing the average payment period.
    (d) increasing the average payment period.

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Managing the Cash Conversion Cycle

36. A firm with a cash conversion cycle of 175 days can stretch its average payment period from 30 days to 45 days. This will result in a/an
    (a) decrease of 15 days in the cash conversion cycle.
    (b) increase of 15 days in the cash conversion cycle.
    (c) decrease of 30 days in the cash conversion cycle.
    (d) increase of 30 days in the cash conversion cycle.

    Answer: A
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Managing the Cash Conversion Cycle (Equation 14.2 and Equation 14.3)

37. A firm has an average age of inventory of 20 days, an average collection period of 30 days, and an average payment period of 60 days. The firm's cash conversion cycle is _________ days.
    (a) 70
    (b) 50
    (c) –10
    (d) 110

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Cash Conversion Cycle (Equation 14.2 and Equation 14.3)

38. An increase in the average collection period will result in _________ in the operating cycle.
    (a) an increase
    (b) a decrease
    (c) an undetermined change
    (d) no change

    Answer: A
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Managing the Operating Cycle

39. An increase in the average payment period will result in _________ in the operating cycle.
    (a) an increase
    (b) a decrease
    (c) an undetermined change
    (d) no change

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Managing the Operating Cycle

40. A decrease in the average age of inventory will result in _________ in the cash conversion cycle.
    (a) an increase
    (b) a decrease
    (c) an undetermined change
    (d) no change

    Answer: B
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Managing the Cash Conversion Cycle

41. An increase in the average payment period will result in _________ in the cash conversion cycle.
    (a) an increase
    (b) a decrease
    (c) an undetermined change
    (d) no change

    Answer: B
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Managing the Cash Conversion Cycle

42. A firm has an average age of inventory of 60 days, an average collection period of 45 days, and an average payment period of 30 days. The firm's operating cycle is _________ days.
    (a) 75
    (b) 105
    (c) 90
    (d) 135

    Answer: B
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Operating Cycle (Equation 14.1)

43. A firm has an operating cycle of 170 days, an average payment period of 50 days, and an average age of inventory of 145 days. The firm's average collection period is _________ days.
    (a) 25
    (b) 75
    (c) 95
    (d) 120

    Answer: A
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Average Collection Period (Equation 14.2 and Equation 14.3)

44. A firm has a cash conversion cycle of 60 days and average collection period of 40 days. The firm's operating cycle is _________ days.
    (a) 20
    (b) 100
    (c) 50
    (d) Cannot be determined

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Operating Cycle (Equation 14.1, Equation 14.2, and Equation 14.3)

45. A firm has an average age of inventory of 101 days, an average collection period of 49 days, and an average payment period of 60 days. The firm's inventory turnover is _________.
    (a) 3.2
    (b) 4.0
    (c) 2.5
    (d) 3.6

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Inventory Turnover (Equation 14.2 and Equation 14.3)

46. The goal of a firm's cash management is to
    (a) increase the cash conversion cycle.
    (b) increase the payment period.
    (c) minimize cash requirement.
    (d) maximize cash outflows.

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Managing the Cash Conversion Cycle

47. One way to improve the cash conversion cycle is to
    (a) speed up collections.
    (b) slow down credit approvals.
    (c) reduce inventory turnover.
    (d) borrow funds.

    Answer: A
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Managing the Cash Conversion Cycle

48. If a firm increases its current assets relative to total assets,
    (a) it increases return and reduces risk.
    (b) it increases return and increases risk.
    (c) it reduces return and reduces risk.
    (d) it reduces return and increases risk.

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Tradeoff between Profitability and Risk

49. A firm with highly unpredictable sales revenue would best choose __________ financing strategy to minimize risk.
    (a) the aggressive
    (b) the conservative
    (c) the trade-off
    (d) a seasonal

    Answer: B
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Conservative Financing Strategy

50. Certain financing plans are termed conservative when
    (a) short-term financing is used frequently.
    (b) working capital is relatively high.
    (c) working capital is relatively low.
    (d) risk is increased.

    Answer: B
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Conservative Financing Strategy

51. An increase in the current asset to total asset ratio has the effects of _________ on profits and _________ on risk.
    (a) an increase; an increase
    (b) an increase; a decrease
    (c) a decrease; a decrease
    (d) a decrease; an increase

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Tradeoff between Profitability and Risk

52. A decrease in the current asset to total asset ratio has the effects of _________ on profits and _________ on risk.
    (a) an increase; an increase
    (b) an increase; a decrease
    (c) a decrease; a decrease
    (d) a decrease; an increase

    Answer: A
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Tradeoff between Profitability and Risk

53. An increase in the current liabilities to total assets ratio has the effects of _________ on profits and _________ on risk.
    (a) an increase; an increase
    (b) an increase; a decrease
    (c) a decrease; a decrease
    (d) a decrease; an increase

    Answer: A
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Tradeoff between Profitability and Risk

54. A decrease in the current liabilities to total assets ratio has the effects of _________ on profits and _________ on risk.
    (a) an increase; an increase
    (b) an increase; a decrease
    (c) a decrease; a decrease
    (d) a decrease; an increase

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Tradeoff between Profitability and Risk

55. The aggressive financing strategy results in the firm financing its short-term needs with _________ funds and its long-term needs with _________ funds.

(a) long-term; short-term
(b) short-term; long-term
(c) permanent; seasonal
(d) seasonal; permanent

Answer: B
Level of Difficulty: 3
Learning Goal: 2
Topic: Aggressive Financing Strategy

Irish Air Services has determined several factors relative to its asset and financing mix.

(a) The firm earns 10 percent annually on its current assets.
(b) The firm earns 20 percent annually on its fixed assets.
(c) The firm pays 13 percent annually on current liabilities.
(d) The firm pays 17 percent annually on long-term funds.
(e) The firm's monthly current, fixed and total asset requirements for the previous year are summarized in the table below:

Table 14.1

Month	**Current Assets**	**Fixed Assets**	**Total Assets**
January	$45,000	$100,000	$145,000
February	40,000	100,000	140,000
March	50,000	100,000	150,000
April	55,000	100,000	155,000
May	60,000	100,000	160,000
June	75,000	100,000	175,000
July	75,000	100,000	175,000
August	75,000	100,000	175,000
September	60,000	100,000	160,000
October	55,000	100,000	155,000
November	50,000	100,000	150,000
December	50,000	100,000	150,000

56. The firm's monthly average permanent funds requirement is (See Table 14.1)

(a) $100,000.
(b) $57,500.
(c) $140,000.
(d) $157,500.

Answer: C
Level of Difficulty: 3
Learning Goal: 2
Topic: Permanent Funding Requirements

57. The firm's monthly average seasonal funds requirement is (See Table 14.1)
    (a) $17,500.
    (b) $57,500.
    (c) $40,000.
    (d) $157,500.

    Answer: A
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Seasonal Funding Requirements

58. The firm's annual financing costs of the aggressive financing strategy are (See Table 14.1)
    (a) $21,175.
    (b) $26,075.
    (c) $24,475.
    (d) $22,775.

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Aggressive Financing Strategy

59. The firm's annual financing costs of conservative financing strategy are (See Table 14.1)
    (a) $22,775.
    (b) $26,075.
    (c) $29,750.
    (d) $21,175.

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Conservative Financing Strategy

60. The firm's annual profits on total assets for the previous year were (See Table 14.1)
    (a) $20,000.
    (b) $21,500.
    (c) $23,625.
    (d) $25,750.

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Profits on Total Assets

61. If the firm's current liabilities in December were $40,000, the net working capital was (See Table 14.1)
(a) $140,000.
(b) $60,000.
(c) $10,000.
(d) –$10,000.

Answer: C
Level of Difficulty: 3
Learning Goal: 2
Topic: Net Working Capital

Table 14.2

Flum Packages, Inc.			
Assets		**Liabilities & Equity**	
Current assets	$10,000	Current Liabilities	$ 5,000
Fixed assets	20,000	Long-term debt	12,000
		Equity	13,000
Total	$30,000	Total	$30,000

The company earns 5 percent on current assets and 15 percent on fixed assets. The firm's current liabilities cost 7 percent to maintain and the average annual cost of long-term funds is 20 percent.

62. The firm's initial ratio of current to total asset is _________. (See Table 14.2)
(a) 1:3
(b) 3:1
(c) 2:3
(d) 3:2

Answer: A
Level of Difficulty: 3
Learning Goal: 2
Topic: Ratio of Current to Total Assets

63. The firm's initial net working capital is (See Table 14.2)
(a) –$ 5,000.
(b) $13,000.
(c) $ 5,000.
(d) $10,000.

Answer: C
Level of Difficulty: 3
Learning Goal: 2
Topic: Net Working Capital

64. The firm's initial annual profits on total assets are (See Table 14.2)
    (a) $2,500.
    (b) $3,500.
    (c) $3,000.
    (d) $4,500.

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Profits on Total Assets

65. If the firm was to shift $3,000 of current assets to fixed assets, the firm's net working capital would _________, the annual profits on total assets would _________, and the risk of technical insolvency would _________, respectively. (See Table 14.2)
    (a) increase; decrease; increase
    (b) decrease; increase; decrease
    (c) increase; decrease; decrease
    (d) decrease; increase; increase

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Tradeoff between Profitability and Risk

66. If the firm was to shift $7,000 of fixed assets to current assets, the firm's net working capital would _________, the annual profits on total assets would _________, and the risk of not being able to meet current obligations would _________, respectively. (See Table 14.2)
    (a) increase; decrease; increase
    (b) decrease; increase; decrease
    (c) increase; decrease; decrease
    (d) decrease; increase; increase

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Tradeoff between Profitability and Risk

67. If the firm was to shift $2,000 of current liabilities to long-term funds, the firm's net working capital would _________, the annual cost of financing would _________, and the risk of technical insolvency would _________, respectively. (See Table 14.2)
    (a) decrease; decrease; increase
    (b) increase; increase; decrease
    (c) decrease; increase; decrease
    (d) increase; decrease; decrease

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Tradeoff between Profitability and Risk

68. The firm would like to increase its current ratio. This goal would be accomplished most profitably by (See Table 14.2)
(a) increasing current liabilities.
(b) decreasing current liabilities.
(c) increasing current assets.
(d) decreasing current assets.

Answer: C
Level of Difficulty: 3
Learning Goal: 2
Topic: Managing Net Working Capital

69. In the aggressive financing strategy, a firm anticipating a large increase in sales should finance the increase in working capital with
(a) the sale of common stock.
(b) the sale of a bond issue.
(c) a line of credit.
(d) a long-term note from the bank.

Answer: C
Level of Difficulty: 3
Learning Goal: 2
Topic: Aggressive Financing Strategy

70. The aggressive financing strategy is risky in two respects: the firm operates with a low level of _________, and the firm has only a limited amount of _________ capacity.
(a) current liabilities; short-term borrowing
(b) net working capital; short-term borrowing
(c) current assets; long-term borrowing
(d) net working capital; long-term borrowing

Answer: B
Level of Difficulty: 3
Learning Goal: 2
Topic: Aggressive Financing Strategy

71. The conservative financing strategy results in financing all projected funds requirements with _________ funds and use of _________ funds in the event of an unexpected cash outflow.
(a) long-term; short-term
(b) short-term; long-term
(c) permanent; seasonal
(d) seasonal; permanent

Answer: A
Level of Difficulty: 3
Learning Goal: 2
Topic: Conservative Financing Strategy

72. In theory, the conservative financing strategy ignores
   (a) all current liabilities.
   (b) the spontaneous forms of short-term financing.
   (c) current assets.
   (d) the high risk associated with this strategy.

   Answer: B
   Level of Difficulty: 3
   Learning Goal: 2
   Topic: Conservative Financing Strategy

73. In economic conditions characterized by a scarcity of short-term funds, a firm would best choose the _________ financing strategy.
   (a) aggressive
   (b) conservative
   (c) permanent
   (d) seasonal

   Answer: B
   Level of Difficulty: 3
   Learning Goal: 2
   Topic: Conservative Financing Strategy

74. A risk of the _________ financing strategy is unpredictable interest expense.
   (a) aggressive
   (b) conservative
   (c) permanent
   (d) seasonal

   Answer: A
   Level of Difficulty: 3
   Learning Goal: 2
   Topic: Aggressive Financing Strategy

75. The _________ financing strategy requires the firm to pay interest on excess funds borrowed but not needed throughout the entire year.
   (a) aggressive
   (b) conservative
   (c) permanent
   (d) seasonal

   Answer: B
   Level of Difficulty: 3
   Learning Goal: 2
   Topic: Conservative Financing Strategy

76. The aggressive financing strategy is _________ method while the conservative financing strategy is _________ method.

(a) a high-profit, high-risk; a low-profit, low-risk
(b) a high-profit, low-risk; a low-profit, high-risk
(c) a low-profit, high-risk; a high-profit, low-risk
(d) a low-profit, low-risk; a high-profit, high-risk

Answer: A
Level of Difficulty: 3
Learning Goal: 2
Topic: Aggressive Financing Strategy

77. In economic conditions characterized by short-term interest rates which exceed long-term interest rates, the financing strategy which would maximize profits is _________ strategy.

(a) the aggressive
(b) the conservative
(c) the trade-off
(d) a seasonal

Answer: B
Level of Difficulty: 3
Learning Goal: 2
Topic: Conservative Financing Strategy

78. An increase in the average payment period will result in _________ in the operating cycle and _________ in the cash conversion cycle.

(a) an increase; a decrease
(b) a decrease; a decrease
(c) a decrease; no change
(d) no change; a decrease

Answer: D
Level of Difficulty: 3
Learning Goal: 2
Topic: Average Payment Period

79. The difference between the number of days resources are tied up in the operating cycle and the number of days the firm can use spontaneous financing before payment is made is the

(a) cash conversion cycle.
(b) average payment period.
(c) average collection period.
(d) average age of inventory.

Answer: A
Level of Difficulty: 3
Learning Goal: 2
Topic: Cash Conversion Cycle

80. A decrease in the production time to manufacture a finished good will result in _________ in the cash conversion cycle.
    (a) an increase
    (b) a decrease
    (c) an undetermined change
    (d) no change

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Managing the Cash Conversion Cycle

81. A firm has annual operating outlays of $1,800,000 and a cash conversion cycle of 60 days. If the firm currently pays 12 percent for negotiated financing and reduces its cash conversion cycle to 50 days, the annual savings is
    (a) $50,000
    (b) $200,000
    (c) $ 6,000.
    (d) $216,000.

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Managing the Cash Conversion Cycle (Equation 14.2 and Equation 14.3)

82. A firm has a cash conversion cycle of 60 days. Annual outlays are $12 million and the cost of negotiated financing is 12 percent. If the firm reduces its average age of inventory by 10 days, the annual savings is _________.
    (a) $104,000
    (b) $144,000
    (c) $ 28,800
    (d) $40,000

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Managing the Cash Conversion Cycle (Equation 14.2 and Equation 14.3)

83. Ideally a firm would like to have a
    (a) negative operating cycle.
    (b) positive operating cycle.
    (c) negative cash conversion cycle.
    (d) positive cash conversion cycle.

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Managing the Cash Conversion Cycle

84. A negative cash conversion cycle
(a) means that the operating cycle exceeds the average payment period.
(b) means that the average payment period exceeds the operating cycle.
(c) indicates that the firm is shortening its average payment period and lengthening its average collection period.
(d) is easy for a manufacturing firm to attain.

Answer: B
Level of Difficulty: 3
Learning Goal: 2
Topic: Managing the Cash Conversion Cycle

85. A firm may have a negative cash conversion cycle if it
(a) carries very little inventory and sells its products on credit.
(b) carries high inventory and sells its products on credit.
(c) carries very little inventory and sells its products for cash.
(d) carries high inventory and sells its products for cash.

Answer: C
Level of Difficulty: 3
Learning Goal: 2
Topic: Managing the Cash Conversion Cycle

86. Improvements to cash management include all of the following EXCEPT a reduction in
(a) the cash turnover.
(b) the cash conversion cycle.
(c) the average age of inventory.
(d) the average collection period.

Answer: A
Level of Difficulty: 3
Learning Goal: 2
Topic: Managing the Cash Conversion Cycle

87. A firm with a cash conversion cycle of 175 days can stretch its average payment period from 30 days to 45 days. This will result in a(n) _________ in the cash conversion cycle of _________ days.
(a) increase; 15
(b) decrease; 15
(c) increase; 45
(d) decrease; 45

Answer: B
Level of Difficulty: 3
Learning Goal: 2
Topic: Managing the Cash Conversion Cycle (Equation 14.2 and Equation 14.3)

88. A firm with a very low current ratio in comparison to the industry standard could lower the risk of unavailable short-term funds by moving toward _________ financing strategy.
    (a) the aggressive
    (b) the conservative
    (c) a permanent
    (d) a seasonal

    Answer: B
    Level of Difficulty: 4
    Learning Goal: 2
    Topic: Conservative Financing Strategy

89. A firm which uses the aggressive financing strategy plans to purchase a major fixed asset financed with a loan. The most likely consequence of this action is
    (a) a decrease in the current ratio.
    (b) an increase in net working capital.
    (c) a decrease in the risk of technical insolvency.
    (d) an increase in long-term debt.

    Answer: D
    Level of Difficulty: 4
    Learning Goal: 2
    Topic: Aggressive Financing Strategy

90. A firm which uses the aggressive financing strategy plans to purchase raw materials in large quantities to take price discounts. The firm will finance the purchase with a loan. The most likely consequence of this action is
    (a) a decrease in the current ratio.
    (b) an increase in net working capital.
    (c) an undetermined change in the current ratio.
    (d) an increase in long-term debt.

    Answer: C
    Level of Difficulty: 4
    Learning Goal: 2
    Topic: Aggressive Financing Strategy

91. The _________ inventory contains the basic components of the production process.
    (a) raw materials
    (b) work-in-process
    (c) finished goods
    (d) capital goods

    Answer: A
    Level of Difficulty: 1
    Learning Goal: 3
    Topic: Composition of Inventory

92. The _________ inventory consists of all items currently in the production process.
(a) raw materials
(b) work-in-process
(c) finished goods
(d) capital goods

Answer: B
Level of Difficulty: 1
Learning Goal: 3
Topic: Composition of Inventory

93. The _________ inventory consists of items that have been produced but not yet sold.
(a) raw materials
(b) work-in-process
(c) finished goods
(d) capital goods

Answer: C
Level of Difficulty: 1
Learning Goal: 3
Topic: Composition of Inventory

94. The three basic types of inventory are all of the following EXCEPT
(a) raw materials
(b) work-in-process
(c) finished goods
(d) capital goods

Answer: D
Level of Difficulty: 1
Learning Goal: 3
Topic: Composition of Inventory

95. All of the following managers would like to have large inventories EXCEPT the _________ manager.
(a) financial
(b) marketing
(c) manufacturing
(d) purchasing

Answer: A
Level of Difficulty: 1
Learning Goal: 3
Topic: Managing Inventory

96. The _________ is a technique that divides inventory into three groups, according to dollar investment.
    (a) exponential smoothing technique
    (b) ABC system
    (c) EOQ model
    (d) LIFO model

    Answer: B
    Level of Difficulty: 1
    Learning Goal: 3
    Topic: ABC Inventory System

97. In the ABC system of inventory management, the _________ method or system could be utilized to control C items.
    (a) basic economic order quantity
    (b) materials requirement planning
    (c) red-line
    (d) just-in-time

    Answer: C
    Level of Difficulty: 1
    Learning Goal: 3
    Topic: ABC Inventory System

98. In the ABC system of inventory management, the _________ method or system is appropriate for monitoring B items.
    (a) basic economic order quantity.
    (b) materials requirement planning
    (c) red-line
    (d) just-in-time

    Answer: A
    Level of Difficulty: 1
    Learning Goal: 3
    Topic: ABC Inventory System

99. The _________ is an inventory technique that takes into account various operating and financial costs to determine the order quantity for a specific inventory item.
    (a) exponential smoothing technique
    (b) ABC system
    (c) EOQ model
    (d) LIFO model

    Answer: C
    Level of Difficulty: 1
    Learning Goal: 3
    Topic: EOQ Inventory Model

100. A computerized inventory system that simulates needed materials requirements for the finished product, and then compares production needs to available inventory balances to determine when orders should be placed is the
   (a) basic economic order quantity system.
   (b) materials requirement planning system.
   (c) just-in-time system.
   (d) red-line method.

   Answer: B
   Level of Difficulty: 1
   Learning Goal: 3
   Topic: Materials Requirement Planning

101. The philosophy of the _________ is that the firm would have only work-in-process inventory.
   (a) basic economic order quantity system
   (b) materials requirement planning system
   (c) just-in-time system
   (d) red-line method

   Answer: C
   Level of Difficulty: 1
   Learning Goal: 3
   Topic: Just-in-time Inventory System

102. The costs associated with inventory can be divided into the following groups EXCEPT
   (a) order costs.
   (b) marginal costs.
   (c) carrying costs.
   (d) total costs.

   Answer: B
   Level of Difficulty: 1
   Learning Goal: 3
   Topic: Types of Inventory Costs

103. Inventory insurance costs are an example of _________ costs.
   (a) order
   (b) marginal
   (c) carrying
   (d) total

   Answer: C
   Level of Difficulty: 1
   Learning Goal: 3
   Topic: Inventory Carrying Costs

104. The _________ uses no, or very little, safety stock.
   (a) basic economic order quantity system
   (b) materials requirement planning system
   (c) just-in-time system
   (d) red-line method

   Answer: C
   Level of Difficulty: 2
   Learning Goal: 3
   Topic: Just-in-time Inventory System

105. In the EOQ model, _________ costs are the variable costs per unit of holding an item of inventory for a specified time period.
   (a) basic
   (b) order
   (c) carrying
   (d) processing

   Answer: C
   Level of Difficulty: 2
   Learning Goal: 3
   Topic: EOQ Inventory Model

106. The economic order quantity (EOQ) is the order quantity which minimizes
   (a) the order cost per order.
   (b) the total inventory costs.
   (c) the carrying costs per unit per period.
   (d) order quantity in units.

   Answer: B
   Level of Difficulty: 2
   Learning Goal: 3
   Topic: EOQ Inventory Model

107. In the EOQ model, if carrying costs increase while all other costs remain unchanged, the number of orders placed would be expected to
   (a) increase.
   (b) decrease.
   (c) remain unchanged.
   (d) change without regard to carrying costs.

   Answer: A
   Level of Difficulty: 2
   Learning Goal: 3
   Topic: EOQ Inventory Model

108. The _________ is an inventory management technique that compares production needs to available inventory balances and determines when orders should be placed for various material inputs.
    (a) ABC system
    (b) EOQ model
    (c) MRP system
    (d) JIT system

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: Materials Requirement Planning

109. The _________ is an inventory management technique that minimizes inventory investment by having materials inputs arrive at exactly the time they are needed for production.
    (a) ABC system
    (b) EOQ model
    (c) MRP system
    (d) JIT system

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: Just-in-time Inventory System

110. The disposition of the financial manager, marketing manager, and manufacturing manager toward inventory levels is to keep them _________, _________, and _________, respectively.
    (a) high; low; high
    (b) low; high; low
    (c) low; high; high
    (d) high; low; low

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Issues in Inventory Management

111. Because managing inventory is just like managing any other investment, decisions about the level of inventory should be guided by
    (a) the value of the inventory.
    (b) the effect of inventory levels on sales.
    (c) a cost-benefit analysis.
    (d) the effect of inventory levels on customer relations.

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Issues in Inventory Management

Bowring Ball Bearings has 10 different items in its inventory. The average number of units held in inventory and the average unit cost are listed for each item. The firm uses an ABC system of inventory control

Table 14.3

	Average Number of Units	**Average Unit Cost**
1	5,000	$0.05
2	2,000	1.50
3	100	8.50
4	500	45.00
5	650	3.50
6	10,000	100.00
7	5,100	0.25
8	3,100	5.00
9	20	0.75
10	1,150	2.00

112. Inventory items that belong in the A category include (See Table 14.3)
 (a) Items 4 and 6.
 (b) Items 1, 6, and 7.
 (c) Items 3 and 9.
 (d) Items 1 and 7.

 Answer: A
 Level of Difficulty: 3
 Learning Goal: 3
 Topic: ABC Inventory System

113. Inventory items that belong in the C category include (See Table 14.3)
 (a) Items 4 and 6.
 (b) Items 1, 6, and 7.
 (c) Items 1, 3, and 9.
 (d) Items 1 and 7.

 Answer: C
 Level of Difficulty: 3
 Learning Goal: 3
 Topic: ABC Inventory System

114. In the EOQ model, _________ costs are the fixed clerical cost of writing a purchase order, processing the paper work, and verifying the invoice.
 (a) basic
 (b) order
 (c) carrying
 (d) processing

 Answer: B
 Level of Difficulty: 3
 Learning Goal: 3
 Topic: EOQ Inventory Model

115. The Steel Works, Inc. is required to carry a minimum of 40 days' raw steel, which is 250 tons. It takes 15 days between order and delivery. At what level of steel would Steel Works reorder?
(a) 3,750 tons
(b) 600 tons
(c) 667 tons
(d) 344 tons

Answer: D
Level of Difficulty: 3
Learning Goal: 3
Topic: Inventory Reorder Point (Equation 14.8)

116. The General Chemical Company uses 150,000 gallons of hydrochloric acid per month. The cost of carrying the chemical in inventory is 50 cents per gallon per year, and the cost of ordering the chemical is $150 per order. The firm uses the chemical at a constant rate throughout the year. It takes 18 days to receive an order once it is placed. The reorder point is
(a) 7,500 gallons.
(b) 25,000 gallons.
(c) 90,000 gallons.
(d) 105,000 gallons.

Answer: C
Level of Difficulty: 3
Learning Goal: 3
Topic: Inventory Reorder Point (Equation 14.8)

117. The General Chemical Company uses 150,000 gallons of hydrochloric acid per month. The cost of carrying the chemical in inventory is 50 cents per gallon per year, and the cost of ordering the chemical is $150 per order. The firm uses the chemical at a constant rate throughout the year. The chemical's economic order quantity is
(a) 32,863 gallons.
(b) 11,619 gallons.
(c) 9,487 gallons.
(d) 1,900 gallons.

Answer: A
Level of Difficulty: 4
Learning Goal: 3
Topic: EOQ Inventory Model (Equation 14.7)

118. A firm's credit _________ provides guidelines for determining whether to extend credit to a customer and how much credit to extend.
(a) scoring
(b) terms
(c) policy
(d) standards

Answer: C
Level of Difficulty: 1
Learning Goal: 4
Topic: Credit Policy

119. _________ is a procedure resulting in a number reflecting the applicant's credit strength, derived as a weighted average of the scores obtained on a variety of key financial and credit characteristics.
(a) Credit scoring
(b) Aging of receivables
(c) Credit analysis
(d) The economic order quantity model

Answer: A
Level of Difficulty: 1
Learning Goal: 4
Topic: Credit Scoring

120. The firm's credit _________ defines the minimum criteria for the extension of credit to a customer.
(a) scoring
(b) terms
(c) policy
(d) standards

Answer: D
Level of Difficulty: 1
Learning Goal: 4
Topic: Credit Standards

121. _________ are established to eliminate the necessity of checking a major customer's credit each time a major purchase is made.
(a) Credit standards
(b) Credit policies
(c) Credit departments
(d) Lines of credit

Answer: D
Level of Difficulty: 1
Learning Goal: 4
Topic: Lines of Credit

122. _________ is the procedure for evaluating mercantile credit applicants.
(a) Credit scoring
(b) Credit standards
(c) Credit policy
(d) Credit analysis

Answer: D
Level of Difficulty: 1
Learning Goal: 4
Topic: Credit Analysis

123. A firm's __________ specifies the repayment terms required of all credit customers.
(a) credit scoring
(b) credit terms
(c) credit policy
(d) credit standards

Answer: B
Level of Difficulty: 1
Learning Goal: 4
Topic: Credit Terms

124. Which of the following is NOT one of the five C's of credit?
(a) character
(b) capital
(c) capability
(d) collateral

Answer: C
Level of Difficulty: 1
Learning Goal: 4
Topic: Five C's of Credit

125. When the creditworthiness of a customer is established, the firm will grant that customer
(a) a credit policy.
(b) a line of credit.
(c) a credit rating.
(d) a credit position.

Answer: B
Level of Difficulty: 1
Learning Goal: 4
Topic: Line of Credit

126. The credit applicant's __________ is its ability to repay the requested credit.
(a) character
(b) capacity
(c) capital
(d) collateral

Answer: B
Level of Difficulty: 1
Learning Goal: 4
Topic: Five C's of Credit

127. The credit applicant's _________ is the financial strength of the applicant as reflected by its ownership position.
    (a) character
    (b) capacity
    (c) capital
    (d) collateral

    Answer: C
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Five C's of Credit

128. The credit applicant's _________ is the amount of assets the applicant has available for use in securing the credit.
    (a) character
    (b) capacity
    (c) capital
    (d) collateral

    Answer: D
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Five C's of Credit

129. The major external sources of credit information are all of the following EXCEPT
    (a) financial statement.
    (b) customers.
    (c) Dun & Bradstreet.
    (d) bank checking.

    Answer: B
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Sources of Credit Information

130. A credit manager typically gives primary attention to _________ in extending credit to an applicant.
    (a) collateral and capacity
    (b) collateral and conditions
    (c) character and capacity
    (d) character and capital

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 4
    Topic: Five C's of Credit

131. While credit scoring provides sound credit information, it is frequently NOT used in business because
   (a) the scoring information is difficult to obtain.
   (b) scoring standards are too rigid.
   (c) most business transactions involve mercantile credit which cannot be scored.
   (d) mercantile credit decisions are easily quantifiable.

   Answer: C
   Level of Difficulty: 2
   Learning Goal: 4
   Topic: Credit Scoring

132. The most important of the five C's of credit are
   (a) collateral and capacity.
   (b) capital and collateral.
   (c) character and capacity.
   (d) character and conditions.

   Answer: C
   Level of Difficulty: 2
   Learning Goal: 4
   Topic: Five C's of Credit

133. The credit applicant's character includes all of the following EXCEPT
   (a) moral commitment to pay.
   (b) level of liquid assets.
   (c) past payment history.
   (d) pending legal judgments.

   Answer: B
   Level of Difficulty: 2
   Learning Goal: 4
   Topic: Five C's of Credit

134. As credit standards are relaxed, sales are expected to _________ and the investment in accounts receivable is expected to _________.
   (a) increase; increase
   (b) increase; decrease
   (c) decrease; decrease
   (d) decrease; increase

   Answer: A
   Level of Difficulty: 2
   Learning Goal: 4
   Topic: Relaxing Credit Standards

135. As credit standards are tightened, sales are expected to _________ and the investment in accounts receivable is expected to _________.
(a) increase; increase
(b) increase; decrease
(c) decrease; decrease
(d) decrease; increase

Answer: C
Level of Difficulty: 2
Learning Goal: 4
Topic: Tightening Credit Standards

136. The major variables that should be considered when evaluating proposed changes in credit standards are all of the following EXCEPT
(a) sales volume.
(b) the investment in accounts receivable.
(c) bad debt expenses.
(d) level of liquid assets.

Answer: D
Level of Difficulty: 2
Learning Goal: 4
Topic: Managing Credit Standards

137. An applicant's capacity to repay the requested credit is shown by
(a) financial statement analysis.
(b) bank account balances.
(c) the applicant's payment history.
(d) the level of assets the applicant can pledge toward the loan.

Answer: A
Level of Difficulty: 3
Learning Goal: 4
Topic: Five C's of Credit

138. A firm is analyzing a relaxation of credit standards that is expected to increase sales 10 percent. The firm is currently selling 400 units at an average sale price per unit of $575, and the variable cost per unit is $400 at the current sales volume. The average cost per unit is $425. What is the additional profit contribution from sales if credit standards are relaxed?
(a) $23,000
(b) $16,000
(c) $6,000
(d) $7,000

Answer: D
Level of Difficulty: 3
Learning Goal: 4
Topic: Relaxing Credit Standards

139. When should credit standards be relaxed?
(a) When sales are expected to increase.
(b) When costs are expected to decrease.
(c) When costs are expected to increase faster than sales if the standards are not relaxed.
(d) When the profit contribution from sales is greater than the cost contribution.

Answer: D
Level of Difficulty: 3
Learning Goal: 4
Topic: Relaxing Credit Standards

Table 14.4

Caren's Canoes is considering relaxing its credit standards to encourage more sales. As a result, sales are expected to increase 15 percent from 300 canoes per year to 345 canoes per year. The average collection period is expected to increase to 40 days from 30 days and bad debts are expected to double the current 1 percent level. The price per canoe is $850, the variable cost per canoe is $650 and the average cost per unit at the 300 unit level is $700. The firm's required return on investment is 20 percent.

140. What is the firm's additional profit contribution from sales under the proposed relaxation of credit standards? (See Table 14.4.)
(a) $2,250
(b) $6,750
(c) $9,000
(d) $69,000

Answer: C
Level of Difficulty: 4
Learning Goal: 4
Topic: Profit Contribution from Sales

141. What is the cost of marginal investments in accounts receivable under the proposed plan? (See Table 14.4)
(a) $1,817
(b) $1,867
(c) $1,733
(d) $1,617

Answer: C
Level of Difficulty: 4
Learning Goal: 4
Topic: Cost of Marginal Investment in Accounts Receivable (Equation 14.9)

142. What is the cost of marginal bad debts under the proposed plan? (See Table 14.4)
(a) $383
(b) $765
(c) $3,315
(d) $5,100

Answer: C
Level of Difficulty: 4
Learning Goal: 4
Topic: Cost of Marginal Bad Debts

143. What is the net result of implementing the proposed plan? (See Table 14.4)
   (a) +$3,952
   (b) –$3,868
   (c) +$2,083
   (d) –$2,083
   Answer: A
   Level of Difficulty: 4
   Learning Goal: 4
   Topic: Net Benefit (Cost) of Relaxing Credit Standards

144. A firm is considering relaxing credit standards, which will result in annual sales increasing from $1.5 million to $1.75 million, the cost of annual sales increasing from $1,000,000 to $1,125,000, and the average collection period increasing from 40 to 55 days. The bad debt loss is expected to increase from 1 percent of sales to 1.5 percent of sales. The firm's required return on investments is 20 percent. The firm's cost of marginal investment in accounts receivable is
   (a) $5,556.
   (b) $9,943.
   (c) $12,153.
   (d) $152,778.
   Answer: C
   Level of Difficulty: 4
   Learning Goal: 4
   Topic: Cost of Marginal Investment in Accounts Receivable (Equation 14.9)

145. A firm is considering relaxing credit standards which will result in an increase in annual sales from $3 million to $3.75 million, a decrease in the cost of annual sales from $2,225,000 to $2,000,000, an increase in additional profit contribution from sales of $10,000, and an increase in the average collection period of 15 days, from 20 to 35 days. The bad debt loss is expected to increase from 1 percent to 1.5 percent of sales. The firm's required return on investments is 15 percent. The net result of the firm relaxing its credit standards is
   (a) $10,000.
   (b) –$16,250.
   (c) –$26,875.
   (d) –$16,875.
   Answer: D
   Level of Difficulty: 4
   Learning Goal: 4
   Topic: Net Benefit (Cost) of Relaxing Credit Standards

146. A firm's credit terms cover all of the following EXCEPT
(a) cash discount.
(b) cash discount period.
(c) credit standards.
(d) credit period.
Answer: C
Level of Difficulty: 1
Learning Goal: 5
Topic: Credit Terms

147. Company _________ are the procedures followed to collect accounts receivable when they come due.
(a) collection policies
(b) credit scorings
(c) credit policies
(d) credit analyses
Answer: A
Level of Difficulty: 1
Learning Goal: 5
Topic: Credit Collection Policy

148. The most stringent step in the collection process is
(a) letters.
(b) personal visits.
(c) collection agencies.
(d) legal action.
Answer: D
Level of Difficulty: 1
Learning Goal: 5
Topic: Credit Collection Policy

149. The first step in the collection of overdue accounts is
(a) a letter.
(b) contacting a collection agency.
(c) legal actions.
(d) a personal visit.
Answer: A
Level of Difficulty: 1
Learning Goal: 5
Topic: Credit Collection Policy

150. 2/15 net 45 translates as
    (a) 15 percent cash discount if paid in 2 days, net 45-day credit period.
    (b) 45 percent of account due in 15 days, payment prior to day 15 receives a 2 percent discount.
    (c) 2 percent cash discount if paid prior to 15 days, if customer does not take a cash discount, the balance is due in 45 days.
    (d) 2 percent of the balance is due in 15 days, the remaining balance is due in 45 days.

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 5
    Topic: Credit Terms

151. A technique that provides the analyst with the information concerning the proportion of each type of account that has been outstanding for a specified period of time is called
    (a) credit analysis.
    (b) credit scoring.
    (c) aging of receivables.
    (d) the economic order quantity model.

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 5
    Topic: Aging of Accounts Receivable

152. When a firm initiates or increases a cash discount, sales are expected to _________, the investment in accounts receivable is expected to _________, the bad debt expense is expected to _________, and the profit per unit is expected to _________.
    (a) decrease; increase; increase; increase
    (b) decrease; decrease; increase; increase
    (c) increase; increase; decrease; decrease
    (d) increase; decrease; decrease; decrease

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 5
    Topic: Initiating or Increasing Cash Discounts

153. When a firm decreases or cancels a cash discount, sales are expected to _________, the investment in accounts receivable is expected to _________, the bad debt expense is expected to _________, and the profit per unit is expected to _________.
    (a) decrease; increase; increase; increase
    (b) decrease; decrease; increase; increase
    (c) increase; increase; decrease; decrease
    (d) increase; decrease; decrease; decrease

    Answer: A
    Level of Difficulty: 3
    Learning Goal: 5
    Topic: Canceling or Decreasing Cash Discounts

154. If the cash discount period is increased, the firm's investment in accounts receivable due to non-discount takers now paying earlier is expected to
(a) increase.
(b) decrease.
(c) not change.
(d) change in an undetermined direction.

Answer: B
Level of Difficulty: 3
Learning Goal: 5
Topic: Initiating or Increasing Cash Discounts

155. If the cash discount period is increased, the firm's investment in accounts receivable due to discount takers still getting cash discounts but paying later is expected to
(a) increase.
(b) decrease.
(c) not change.
(d) change in an undetermined direction.

Answer: A
Level of Difficulty: 3
Learning Goal: 5
Topic: Initiating or Increasing Cash Discounts

156. If the firm's cash discount period is decreased or cancelled, the sales volume can be expected to _________, the bad debt expenses can be expected to _________, and the profit per unit can be expected to _________.
(a) increase; decrease; decrease
(b) increase; increase; decrease
(c) decrease; increase; increase
(d) decrease; decrease; increase

Answer: C
Level of Difficulty: 3
Learning Goal: 5
Topic: Canceling or Decreasing the Cash Discount Period

157. If the firm's cash discount period is increased, the sales volume can be expected to _________, the bad debt expenses can be expected to _________, and the profit per unit can be expected to _________.
(a) increase; decrease; decrease
(b) increase; increase; decrease
(c) decrease; increase; increase
(d) decrease; decrease; increase

Answer: A
Level of Difficulty: 3
Learning Goal: 5
Topic: Initiating or Increasing the Cash Discount Period

158. If the firm's credit period is increased, the sales volume can be expected to _________, the investment in accounts receivable can be expected to _________, and the bad debt expenses can be expected to _________.
   (a) increase; decrease; decrease
   (b) increase; increase; decrease
   (c) increase; increase; increase
   (d) decrease; decrease; decrease

   Answer: C
   Level of Difficulty: 3
   Learning Goal: 5
   Topic: Initiating or Increasing the Credit Period

159. If the firm's credit period is decreased, the sales volume can be expected to _________, the investment in accounts receivable can be expected to _________, and the bad debt expenses can be expected to _________.
   (a) increase; decrease; decrease
   (b) increase; increase; decrease
   (c) increase; increase; increase
   (d) decrease; decrease; decrease

   Answer: D
   Level of Difficulty: 3
   Learning Goal: 5
   Topic: Canceling or Decreasing the Credit Period

A breakdown of Teffan, Inc.'s outstanding accounts receivable dated June 30, 2003 on the basis of the month in which the credit sale was initially made follows. The firm extends 30-day credit terms.

Table 14.5

Month of Credit Sale	Accounts Receivable
June, 2003	$ 410,000
May, 2003	340,000
April, 2003	270,000
March, 2003	200,000
February, 2003 or before	100,000
Total	$1,320,000

160. Accounts receivable over 90 days total (See Table 14.5)
   (a) $200,000.
   (b) $470,000.
   (c) $300,000.
   (d) $100,000.

   Answer: C
   Level of Difficulty: 3
   Learning Goal: 5
   Topic: Aging of Accounts Receivable

161. An evaluation of the firm's collection efforts based on the aging schedule would suggest (See Table 14.5)
   (a) poor credit management.
   (b) satisfactory credit management.
   (c) superior credit management.
   (d) overzealous collection efforts.

   Answer: A
   Level of Difficulty: 3
   Learning Goal: 5
   Topic: Aging of Accounts Receivable

162. An increase in collection efforts will result in _________ in sales volume, _________ in the investment in accounts receivable, _________ in bad debt expenses, and _________ in collection expenditures.
   (a) an increase; a decrease; an increase; a decrease
   (b) an increase; a decrease; a decrease; an increase
   (c) an increase; a decrease; an increase; an increase
   (d) a decrease; a decrease; a decrease; an increase

   Answer: D
   Level of Difficulty: 3
   Learning Goal: 5
   Topic: Increasing Collection Efforts

163. A decrease in collection efforts will result in _________ in sales volume, _________ in the investment in accounts receivable, _________ in bad debt expenses, and _________ in collection expenditures.
   (a) an increase; an increase; an increase; a decrease
   (b) an increase; a decrease; an increase; an increase
   (c) an increase; a decrease; an increase; a decrease
   (d) a decrease; a decrease; a decrease; an increase

   Answer: A
   Level of Difficulty: 3
   Learning Goal: 5
   Topic: Decreasing Collection Efforts

164. An increase in accounts receivable turnover due to an increase in collection efforts will
   (a) decrease the firm's marginal investments in accounts receivable.
   (b) increase the firm's marginal investments in accounts receivable.
   (c) decrease the firm's collection expense.
   (d) increase the firm's bad debt expense.

   Answer: A
   Level of Difficulty: 3
   Learning Goal: 5
   Topic: Increasing Collection Efforts

Table 14.6

Dizzy Animators, Inc. currently makes all sales on credit and offers no cash discount. The firm is considering a 3 percent cash discount for payment within 10 days. The firm's current average collection period is 90 days, sales are 400 films per year, selling price is $25,000 per film, variable cost per film is $18,750 per film, and the average cost per film is $21,000. The firm expects that the change in credit terms will result in a minor increase in sales of 10 films per year, that 75 percent of the sales will take the discount, and the average collection period will drop to 30 days. The firm's bad debt expense is expected to become negligible under the proposed plan. The bad debt expense is currently 0.5 percent of sales. The firm's required return on equal-risk investments is 20 percent.

165. What is the firm's marginal profit contribution from sales under the proposed plan of initiating the cash discount? (See Table 14.6)

(a) $22,500
(b) $40,000
(c) $62,500
(d) $100,000

Answer: C
Level of Difficulty: 4
Learning Goal: 5
Topic: Profit Contribution from Sales

166. What is the marginal investment in accounts receivable under the proposed plan? (See Table 14.6)

(a) $1,234,375
(b) $1,382,500
(c) $1,567,300
(d) $1,841,570

Answer: A
Level of Difficulty: 4
Learning Goal: 5
Topic: Marginal Investment in Accounts Receivable (Equation 14.98)

167. What is the cost of marginal investment in accounts receivable under the proposed plan? (See Table 14.6)

(a) $313,460
(b) $276,500
(c) $246,875
(d) $368,314

Answer: C
Level of Difficulty: 4
Learning Goal: 5
Topic: Cost of Marginal Investment in Accounts Receivable (Equation 14.9)

168. What are the savings of marginal bad debts under the proposed plan? (See Table 14.6)
(a) $500,000
(b) $50,000
(c) $10,000
(d) $5,000

Answer: B
Level of Difficulty: 4
Learning Goal: 5
Topic: Cost of Marginal Bad Debts

169. What is the cost of the marginal cash discount? (See Table 14.6)
(a) $768,750
(b) $300,000
(c) $307,500
(d) $230,625

Answer: D
Level of Difficulty: 4
Learning Goal: 5
Topic: Cost of Marginal Cash Discount

170. What is the net result of increasing the cash discount? (See Table 14.6)
(a) +$33,750
(b) –$33,750
(c) +$128,750
(d) –$58,750

Answer: C
Level of Difficulty: 4
Learning Goal: 5
Topic: Net Benefit (Cost) of Increasing the Cash Discount

171. When managing accounts payable, a good strategy to employ that won’t hurt your credit rating is to
(a) pay early.
(b) pay as late as possible.
(c) never pay.
(d) pay on the due date.

Answer: B
Level of Difficulty: 1
Learning Goal: 6
Topic: Managing Accounts Payable

172. Delaying the payment of accounts payable in order to improve cash management is known as
   (a) ruining the firm's credit rating.
   (b) stretching the payables.
   (c) reducing optimal cash requirements.
   (d) float.

   Answer: B
   Level of Difficulty: 1
   Learning Goal: 6
   Topic: Managing Accounts Payable

173. When managing accounts receivable, a good strategy to employ without losing future sales is to
   (a) send the accounts to a collection agency.
   (b) tighten the credit terms.
   (c) offer cash discount.
   (d) make frequent personal visits to the customer.

   Answer: C
   Level of Difficulty: 1
   Learning Goal: 6
   Topic: Managing Accounts Receivable

174. _________ are short-term money market instruments that can be easily converted into cash.
   (a) Preferred stocks
   (b) Treasury bonds
   (c) Accounts receivable
   (d) Marketable securities

   Answer: D
   Level of Difficulty: 1
   Learning Goal: 6
   Topic: Marketable Securities

175. The depth of a market is determined by
   (a) the ability to absorb the purchase or sale of a large number of securities.
   (b) the number of participants.
   (c) the ability to absorb the purchase or sale of a large dollar amount of securities.
   (d) the safety of principal.

   Answer: C
   Level of Difficulty: 1
   Learning Goal: 6
   Topic: Breadth and Depth of the Market

176. _________ are obligations of the U.S. Treasury with common maturities of 91 to 182 days and that have a strong secondary market.
(a) Treasury notes
(b) Treasury bills
(c) Federal agency issues
(d) Banker's acceptances

Answer: B
Level of Difficulty: 1
Learning Goal: 6
Topic: Treasury Bills

177. _________ are obligations of the U.S. Treasury with common maturities of one to seven years and that are generally issued in minimum denominations of $5,000.
(a) Treasury notes
(b) Treasury bills
(c) Federal agency issues
(d) Banker's acceptances

Answer: A
Level of Difficulty: 1
Learning Goal: 6
Topic: Treasury Notes

178. _________ are not obligations of the U.S. Government, but most purchasers feel that they are implicitly guaranteed by the federal government.
(a) Treasury notes
(b) Treasury bills
(c) Federal agency issues
(d) Banker's acceptances

Answer: C
Level of Difficulty: 1
Learning Goal: 6
Topic: Federal Agency Issues

179. All of the following securities are government issues EXCEPT
(a) Treasury notes.
(b) Treasury bills.
(c) Federal agency issues.
(d) Eurodollar deposits.

Answer: D
Level of Difficulty: 1
Learning Goal: 6
Topic: Eurodollar Deposits

180. _________ is a short-term, unsecured promissory note issued by a corporation with a very high credit standing.
   (a) A negotiable certificate of deposit
   (b) A repurchase agreement
   (c) A money market mutual fund
   (d) A commercial paper

   Answer: D
   Level of Difficulty: 1
   Learning Goal: 6
   Topic: Commercial Paper

181. _________ arise from a short-term credit arrangement used by businesses to finance transactions involving firms in foreign countries or firms with unknown credit capacities.
   (a) Negotiable certificates of deposit
   (b) Eurodollar deposits
   (c) Banker's acceptances
   (d) Money market mutual funds

   Answer: C
   Level of Difficulty: 1
   Learning Goal: 6
   Topic: Banker's Acceptances

182. _________ are funds denominated in U.S. dollars and deposited in banks located outside the United States.
   (a) Negotiable certificates of deposit
   (b) Eurodollar deposits
   (c) Banker's acceptances
   (d) Money market mutual funds

   Answer: B
   Level of Difficulty: 1
   Learning Goal: 6
   Topic: Eurodollar Deposits

183. A _________ is a professionally managed portfolio of marketable securities and is sold in fractional parts.
   (a) negotiable certificate of deposit
   (b) repurchase agreement
   (c) money market mutual fund
   (d) commercial paper issue

   Answer: C
   Level of Difficulty: 1
   Learning Goal: 6
   Topic: Money Market Mutual Funds

184. The nongovernmental issues typically have slightly higher yields than government issues with similar maturities due to the slightly _________ associated with them.
(a) higher profitability
(b) higher risk
(c) lower risk
(d) stronger secondary market

Answer: B
Level of Difficulty: 1
Learning Goal: 6
Topic: Governmental versus Nongovernmental Marketable Securities

185. The principal nongovernmental marketable securities are all of the following EXCEPT
(a) agency issues.
(b) Eurodollar deposits.
(c) money market mutual funds.
(d) negotiable certificate of deposit.

Answer: A
Level of Difficulty: 1
Learning Goal: 6
Topic: Nongovernmental Marketable Securities

186. Funds on deposit at commercial banks having variable maturities and yields based on size, maturity, and prevailing money market conditions are
(a) negotiable certificates of deposit.
(b) commercial paper.
(c) savings accounts.
(d) money market mutual funds.

Answer: A
Level of Difficulty: 1
Learning Goal: 6
Topic: Negotiable Certificates of Deposit

187. _________ refers to funds that have been dispatched by a payer but are not in a form that can be spent by the payee.
(a) The cash conversion cycle
(b) Float
(c) A direct send
(d) Lockboxes

Answer: B
Level of Difficulty: 2
Learning Goal: 6
Topic: Float

188. _________ float results from the delay between the time when a customer deducts a payment from the checking account ledger and the time when the vendor actually receives the funds in a spendable form.
(a) Mail
(b) Processing
(c) Collection
(d) Disbursement

Answer: C
Level of Difficulty: 2
Learning Goal: 6
Topic: Collection Float

189. _________ float results from the lapse between the time when a firm deducts a payment from its checking account ledger and the time when funds are actually withdrawn from its account.
(a) Mail
(b) Processing
(c) Collection
(d) Disbursement

Answer: D
Level of Difficulty: 2
Learning Goal: 6
Topic: Disbursement Float

190. The basic components of collection float include all of the following EXCEPT _________ float.
(a) mail
(b) processing
(c) clearing
(d) disbursement

Answer: D
Level of Difficulty: 2
Learning Goal: 6
Topic: Collection Float

191. _________ float is the time that elapses between the deposit of a check by the payee and the actual availability of funds. This component is attributable to the time required for a check to go through the banking system.
(a) Mail
(b) Processing
(c) Clearing
(d) Disbursement

Answer: C
Level of Difficulty: 2
Learning Goal: 6
Topic: Clearing Float

192. A customer sends payment to a post office box which is emptied by the firm's bank daily. The bank then processes the payments and notifies the firm of the day's collections. This collection technique is known as
    (a) a direct send.
    (b) concentration banking.
    (c) the lockbox system.
    (d) controlled disbursing.

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 6
    Topic: Lockbox System

193. _________ float is the delay between the receipt of a check and the actual deposit of it into the firm's account.
    (a) Disbursement
    (b) Deposit
    (c) Processing
    (d) Clearing

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 6
    Topic: Processing Float

194. Disbursement float has all of the following basic components EXCEPT
    (a) mail.
    (b) processing.
    (c) collection.
    (d) clearing

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 6
    Topic: Disbursement Float

195. A _________ is an unsigned check drawn on one of the firm's bank accounts and deposited into its account at another bank.
    (a) direct send
    (b) wire transfer
    (c) depository transfer check
    (d) preauthorized check

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 6
    Topic: Depository Transfer Checks

196. A _________ is a telegraphic communication that, via bookkeeping entries, removes funds from the payer's bank and deposits them in an account of the payee's bank.
   (a) direct send
   (b) wire transfer
   (c) depository transfer check
   (d) preauthorized check

   Answer: B
   Level of Difficulty: 2
   Learning Goal: 6
   Topic: Wire Transfer

197. _________ involves the strategic use of mailing points and bank accounts to lengthen mail and clearing floats.
   (a) A direct send
   (b) Concentration banking
   (c) A lockbox
   (d) Controlled disbursing

   Answer: D
   Level of Difficulty: 2
   Learning Goal: 6
   Topic: Controlled Disbursing

198. _________ is a method of consciously anticipating the mail, processing, and clearing time involved with the payment process.
   (a) Controlled disbursing
   (b) Concentration banking
   (c) Playing the float
   (d) An overdraft system

   Answer: C
   Level of Difficulty: 2
   Learning Goal: 6
   Topic: Managing the Float

199. A _________ is not a specific security but an arrangement whereby a bank or security dealer sells specific marketable securities to a firm and agrees to repurchase the securities in the future.
   (a) negotiable certificate of deposit
   (b) repurchase agreement
   (c) money market mutual fund
   (d) commercial paper issue

   Answer: B
   Level of Difficulty: 2
   Learning Goal: 6
   Topic: Repurchase Agreement

200. The yield on commercial paper is generally higher than the yield on
    (a) negotiable CDs.
    (b) a corporate bond.
    (c) common stock.
    (d) a Treasury bill.

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 6
    Topic: Commercial Paper

201. Each of the following instruments demonstrates the safety of principal characteristic common to marketable securities EXCEPT
    (a) Treasury bills.
    (b) Treasury notes.
    (c) banker's acceptances.
    (d) common stock.

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 6
    Topic: Marketable Securities

202. The ease of salability of marketable securities refers to
    (a) safety of return.
    (b) safety of principal.
    (c) safety of maturity.
    (d) risk of payments.

    Answer: B
    Level of Difficulty: 2
    Learning Goal: 6
    Topic: Marketable Securities

203. Short-term instruments issued by the Federal Home Loan Bank, the Federal National Mortgage Association, and the Federal Land Bank are examples of
    (a) Treasury notes.
    (b) Treasury bills.
    (c) federal agency issues.
    (d) banker's acceptances.

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 6
    Topic: Federal Agency Issues

204. Sound cash management techniques would support
(a) minimizing collection float, maximizing disbursement float, and minimizing the cash conversion cycle.
(b) minimizing collection float, maximizing disbursement float, and minimizing the cash turnover.
(c) maximizing collection float, minimizing disbursement float, and minimizing operating cash.
(d) minimizing collection float, maximizing disbursement float, and maximizing operating cash.

Answer: A
Level of Difficulty: 3
Learning Goal: 6
Topic: Managing the Float

205. A firm expects to have funds of $150,000 idle for 60 days. If the firm could purchase marketable securities yielding 10 percent and pay brokerage fees of $1,500, the firm
(a) should make the investment since interest earned exceeds brokerage fees.
(b) should not make the investment since brokerage fees exceed interest earned.
(c) should leave the $150,000 in cash.
(d) should invest the funds for more than 60 days due to the favorable rate.

Answer: A
Level of Difficulty: 3
Learning Goal: 6
Topic: Marketable Securities Management

206. The risk of an investment in a Eurodollar deposit is partially due to
(a) the fact that the center of the Eurodollar market is in London.
(b) the fact that the majority of these deposits are not in the form of U.S. dollars.
(c) the presence of some foreign exchange risk.
(d) the fact that these instruments only pay interest at maturity.

Answer: C
Level of Difficulty: 3
Learning Goal: 6
Topic: Eurodollar Deposits

207. Which of the following is true of a Eurodollar deposit?
(a) Eurodollar deposits tend to provide yields below nearly all other marketable securities with similar maturities due to their low risk.
(b) Eurodollar deposits are non-negotiable and pay interest only at maturity, hence the yield is higher than on other marketable securities with similar maturities.
(c) Eurodollar deposits tend to provide yields above nearly all other marketable securities with similar maturities due to the higher risk.
(d) Eurodollar deposits tend to provide higher yields above nearly all other marketable securities with similar maturities due to the absence of an active secondary market.

Answer: C
Level of Difficulty: 4
Learning Goal: 6
Topic: Eurodollar Deposits

208. Depository banks holding Eurodollar deposits are
(a) generally more closely regulated than U.S. banks and are therefore more risky.
(b) generally less closely regulated than U.S. banks and are therefore more risky.
(c) generally more closely regulated than U.S. banks and are therefore less risky.
(d) largely located outside of the European countries and are therefore more risky.

Answer: B
Level of Difficulty: 4
Learning Goal: 6
Topic: Eurodollar Deposits

209. A firm has arranged for a lockbox system to reduce collection time of accounts receivable. Currently the firm has an average collection period of 43 days, an average age of inventory of 50 days, and an average payment period of 10 days. The lockbox system will reduce the average collection period by 3 days by reducing processing, mail, and clearing float. The firm's cash conversion cycle _________.
(a) increases by 3 days
(b) decreases by 3 days
(c) will not change
(d) is 93 days

Answer: B
Level of Difficulty: 4
Learning Goal: 6
Topic: Lockbox System

210. A popular extension of materials requirement planning that integrates data from numerous areas such as accounting, finance, engineering, and manufacturing using a sophisticated computer system is called
(a) computerized materials integration II.
(b) manufacturing resource planning II.
(c) inventory allocation planning II.
(d) none of the above.

Answer: B
Level of Difficulty: 3
Learning Goal: 3
Topic: Lockbox System

■ Essay Questions

1. Minny Fishing Products is analyzing the performance of its cash management. On the average, the firm holds inventory 65 days, pays its suppliers in 35 days, and collects its receivables in 15 days. The firm has a current annual outlay of $1,960,000 on operating cycle investments. Minny currently pays 10 percent for its negotiated financing. (Assume a 360 day year.)

(a) Calculate the firm's cash conversion cycle.

(b) Calculate the firm's operating cycle.

(c) Calculate the daily expenditure and the firm's annual savings if the operating cycle is reduced by 15 days.

Answers:

(a) CCC = 65 + 15 – 35 = 45

(b) OC = 65 + 15 = 80

(c) Daily expenditure = $1,960,000/360 = $5,444.44
Annual savings = $5,444.44 × 15 × 0.10 = $8,167

Level of Difficulty: 3
Learning Goal: 2
Topic: Managing the Operating and Cash Conversion Cycles (Equation 14.1, Equation 14.2, and Equation 14.3)

2. A firm has arranged for a lockbox system to reduce collection time of accounts receivable. Currently the firm has an average collection period of 43 days, an average age of inventory of 50 days, and an average payment period of 10 days. The lockbox system will reduce the average collection period by three days by reducing processing, mail, and clearing float. The firm has total annual outlays of $15,000,000 and currently pays 9 percent for its negotiated financing.

(a) Calculate the cash conversion cycle before and after the lockbox system.

(b) Calculate the savings in financing costs from the lockbox system.

Answers:

(a) CCC before lockbox = 43 + 50 – 10 = 83
CCC after lockbox = 40 + 50 – 10 = 80

(b) $15,000,000/360 = $41,666.67 per day × 3 × 0.09 = $11,250

Level of Difficulty: 3
Learning Goal: 2
Topic: Lockbox System and the Cash Conversion Cycle (Equation 14.2 and Equation 14.3)

3. Ligure Jewelers has seasonal financing needs that vary from $250,000 to $2,725,000. The permanent financing requirement is $4,100,000. Check the appropriate box indicating the better strategy for each of the following events.

Event	Aggressive Financing Strategy	Conservative Financing Strategy
1. Due to high inflation, short-term interest rates are much higher than long-term rates.	—	—
2. Sales revenue is unpredictable.	—	—
3. The firm has a large proportion of its assets in fixed assets.	—	—
4. The average seasonal financing need is $1,000,000.	—	—
5. The average seasonal financing need is $2,000,000.	—	—

Answer:

Event	Aggressive Financing Strategy	Conservative Financing Strategy
1. Due to high inflation, short-term interest rates are much higher than long-term rates.	—	X
2. Sales revenue is unpredictable.	—	X
3. The firm has a large proportion of its assets in fixed assets.	—	X
4. The average seasonal financing need is $1,000,000.	X	—
5. The average seasonal financing need is $2,000,000.	—	X

Level of Difficulty: 3
Learning Goal: 2
Topic: Aggressive versus Conservative Financing Strategy

Table 14.7

Ace Business Forms			
Month	**Current Assets**	**Fixed Assets**	**Total Assets**
January	$125,000	$250,000	$375,000
February	130,000	250,000	380,000
March	135,000	250,000	385,000
April	150,000	250,000	400,000
May	150,000	250,000	400,000
June	125,000	250,000	375,000
July	115,000	250,000	365,000
August	120,000	250,000	370,000
September	115,000	250,000	370,000
October	100,000	250,000	350,000
November	110,000	250,000	360,000
December	115,000	250,000	365,000

4. Ace Business Forms has compiled several factors relative to its financing mix. The firm pays 8 percent on short-term funds and 10 percent on long-term funds. The firm's monthly current, fixed and total asset requirements for the previous year are summarized in Table 14.7.

Determine:

(a) the monthly average permanent funds requirement
(b) the monthly average seasonal funds requirement
(c) the annual financing costs (aggressive strategy)
(d) the annual financing costs (conservative strategy)

Answers:

(a) $350,000
(b)

Month	**Total Assets**	**Permanent Requirement**	**Seasonal Requirement**
January	$375,000	$350,000	$25,000
February	380,000	350,000	30,000
March	385,000	350,000	35,000
April	400,000	350,000	50,000
May	400,000	350,000	50,000
June	375,000	350,000	25,000
July	365,000	350,000	15,000
August	370,000	350,000	20,000
September	370,000	350,000	15,000
October	350,000	350,000	0
November	360,000	350,000	10,000
December	365,000	350,000	15,000
Monthly Average			$24,167

(c)

$350,000 (0.10)	= $35,000
24,167 (0.08)	= 1,933
Total financing cost (Aggressive strategy)	$36,933

(d) Total financing cost (Conservative strategy) = $400,000 (0.10) = $40,000

Level of Difficulty: 4
Learning Goal: 2
Topic: Aggressive versus Conservative Financing Strategy

5. Ace Business Forms pays 8 percent on short-term funds and 10 percent on long-term funds. Determine its annual financing costs using the trade-off strategy described: Ace Business Forms has seasonal financing requirements ranging from zero to $50,000 per month. Based on this range, the firm has decided to finance $25,000 per month of the seasonal funds with long-term debt and the rest of the seasonal funds with short-term debt. The permanent funds requirement will be financed with long-term funds. (See Table 14.7)

Answer: Trade-off strategy annual financing costs:

($350,000 + $25,000) (0.10)	= $37,500
($ 5,417) (0.08)	= 433
	$37,933

Level of Difficulty: 4
Learning Goal: 2
Topic: Trade-off Financing Strategy

6. Studio One, a dealer in contemporary art, has forecasted its seasonal financing needs for the next six months as follows:

Month	Seasonal Requirement
January	$1,450,000
February	1,895,000
March	2,000,000
April	1,575,000
May	1,342,000
June	1,562,000

(a) The firm projects short-term funds will cost 11 percent and long-term funds will cost 13 percent annually.
(b) The firm's permanent funds requirement is $500,000.

Calculate financing costs for the first six months using the aggressive and conservative strategies.

Answer: Average monthly seasonal funds requirement:
$9,824,000/6 = $1,637,333

Aggressive strategy:

$1,637,333 (0.11/2)	= $ 90,053
500,000 (0.13/2)	= 32,500
	$122,553

Conservative strategy:
$2,500,000 (0.13/2) = $162,500

Level of Difficulty: 4
Learning Goal: 2
Topic: Aggressive versus Conservative Financing Strategy

7. Tim's Sons Company is interested in making sure they have enough money to finance their assets. The company's current assets and fixed assets for the months of January through December are given in the following table.

Month	**Current Assets**	**Fixed Assets**	**Total Assets**
January	$60,000	$70,000	$130,000
February	58,000	70,000	128,000
March	55,000	70,000	125,000
April	47,000	70,000	117,000
May	40,000	70,000	110,000
June	41,000	70,000	111,000
July	40,000	70,000	110,000
August	37,000	70,000	107,000
September	38,000	70,000	108,000
October	33,000	70,000	103,000
November	40,000	70,000	110,000
December	50,000	70,000	120,000

(a) Find the average monthly seasonal and permanent funds requirement.

(b) What is the total cost of financing under the aggressive and conservative strategies. Assume short-term funds costs 4.5 percent and the interest rate for long-term funds is 12 percent.

(c) Find the net working capital under the aggressive and conservative strategies.

Answers:

Month	Current Assets	Fixed Assets	Total Assets	Permanent Requirement	Seasonal Requirement
January	$60,000	$70,000	$130,000	$103,000	$27,000
February	58,000	70,000	128,000	$103,000	25,000
March	55,000	70,000	125,000	$103,000	22,000
April	47,000	70,000	117,000	$103,000	14,000
May	40,000	70,000	110,000	$103,000	7,000
June	41,000	70,000	111,000	$103,000	8,000
July	40,000	70,000	110,000	$103,000	7,000
August	37,000	70,000	107,000	$103,000	4,000
September	38,000	70,000	108,000	$103,000	5,000
October	33,000	70,000	103,000	$103,000	0
November	40,000	70,000	110,000	$103,000	7,000
December	50,000	70,000	120,000	$103,000	17,000
					$143,000

(a) Monthly permanent requirement = $103,000
Average seasonal requirement = 143,000/12 = $11,916.67

(b) Aggressive:

Total costs = 11,916.67 × 0.045 + 103,000 × 0.12 = $12,896.25

Conservative:
Total costs = 103,000 × 0.12 = $15,600

(c) Net Working Capital:

Aggressive Strategy: $33,000
Conservative Strategy: $60,000

Level of Difficulty: 4
Learning Goal: 2
Topic: Aggressive versus Conservative Financing Strategy

8. Sansatrip Products has ten different items in its finished goods inventory. The average number of units held in inventory and the average unit cost are listed for each item. The firm uses an ABC system of inventory control.

Item	Average Number of Units in Inventory	Average Cost Per Unit
1	3,000	$1.50
2	500	10.00
3	4,000	12.00
4	50	40.00
5	10,000	5.00
6	340	15.00
7	1,500	3.00
8	460	30.00
9	2,500	25.00
10	390	4.10

(a) Which items should be considered to be in the A category of an ABC system of inventory?
(b) Which items should be considered to be in the B category of an ABC system of inventory?

Answers:

Item	Average Cost Per Unit	Average Number of Units in Inventory	Average Investment
1	$1.50	3,000	$ 4,500
2	10.00	500	5,000
3	12.00	4,000	48,000
4	40.00	50	2,000
5	5.00	10,000	50,000
6	15.00	340	5,100
7	3.00	1,500	4,500
8	30.00	460	13,800
9	25.00	2,500	62,500
10	4.10	390	1,599
		Total	$196,999

(a) Items 3, 5, and 9 should be considered in the A category.
(b) Item 10 clearly belongs to the C category. All the rest of the inventory items have about an equal investment and most likely belong in the B category.

Level of Difficulty: 3
Learning Goal: 3
Topic: ABC Inventory Management System

9. Contex, Inc. uses 800 units of a product per year on a continuous basis. The product has carrying costs of $50 per unit per year and order costs of $300 per order. It takes 30 days to receive a shipment after an order is placed and the firm requires a safety stock of 5 days usage in inventory.
(a) Calculate the economic order quantity (EOQ).
(b) Determine the reorder point.

Answers:

(a) EOQ = $\sqrt{(2 \times 800 \times \$300)/50}$ = 98 units
(b) Reorder point = [30 days × (800/360)] + [5 × (800/360)] = 66.7 + 11.11 = 77.81 – 78 units

Level of Difficulty: 3
Learning Goal: 3
Topic: EOQ Inventory Model and Inventory Reorder Point (Equation 14.7 and Equation 14.8)

10. Sharon's Apple Farm uses 12,600 baskets a year for apple shipment. Determine the optimum order quantity of baskets assuming the order costs per order is $600 and it costs $2 to carry a unit of basket in inventory per period.

Answer: EOQ $= \sqrt{(2 \times 12{,}600 \times \$600)/2}$ = 2,750 units

Level of Difficulty: 3
Learning Goal: 3
Topic: EOQ Inventory Model (Equation 14.7)

11. Sharon uses 35 baskets each day to pack apples for shipping. It takes 5 days to receive a shipment of baskets after an order is placed and she would like a safety stock of 3 days in inventory. At what level of inventory should Sharon place an order for baskets?

Answer: Reorder point = 5 × 35 + 3 × 35 = 280 units

Level of Difficulty: 3
Learning Goal: 3
Topic: Inventory Reorder Point (Equation 14.8)

12. Data products, Inc., uses 2,400 units of a product per year on a continuous basis. The product carrying costs are $60 per year and ordering costs are $250 per order. It takes 20 days to receive a shipment after an order is placed and the firm requires a safety stock of 8 days of usage in inventory.
(a) Calculate the economic order quantity (round up to the nearest whole unit).
(b) Calculate the total cost per year to order and carry this item.
(c) Their supplier has notified the company that if they increase their order quantity by 58 units they will give the company a discount. Calculate the dollar discount that the company will have to give Dataproducts to result in a net benefit to the company.

Answers:

(a) EOQ = $\sqrt{(2 \times 2{,}400 \times 250)/60}$ = 142 units
(b) Total cost = (2,400/142)($250) + (142/2)($60) = $8,485
(c) Total cost at new level = (2,400/200)($250) + (200/2)($60) = $9,000

The yearly discount will have to be at least $515 ($9,000–$8,485) to make the decision neutral; over $515 to result in a net benefit to the company.

Level of Difficulty: 4
Learning Goal: 3
Topic: EOQ Inventory Model and Safety Stock (Equation 14.7)

13. Nellie's Finery

Credit Scoring Policy

Financial and Credit Characteristics	**Predetermined Weight**
Credit references	0.25
Education	0.05
Home ownership	0.15
Income range	0.30
Payment history	0.15
Years on job	0.10

Financial and Credit Characteristics	**Applicant A**	**Applicant B**
Credit references	90	70
Education	80	95
Home ownership	70	50
Income range	50	95
Payment history	75	70
Years on job	80	70

Nellie's Finery uses the credit scoring technique to evaluate retail applications. The financial and credit characteristics considered and weights indicating their relative importance in the credit decision are shown above. The firm's credit standards are to accept all applicants with credit scores of 85 or more, to extend limited credit to applicants with scores ranging from 75 to 84, and to reject all applicants below 75. The firm is currently processing two applicants. The scores of each applicant on each of the financial and credit characteristics are summarized above. Would you recommend either of these applicants for credit extension?

Answer: Applicant A's credit score = 71.25
Applicant B's credit score = 75.75
Reject Applicant A and accept Applicant B on a limited basis.

Level of Difficulty: 3
Learning Goal: 4
Topic: Managing Credit Standards

14. Krug Gold Coin, Inc. is considering shortening its credit period from 30 days to 20 days and believes, as a result of this change, its average collection period will decrease from 36 days to 30 days. Bad debt expenses are also expected to decrease from 1.2 percent to 0.8 percent of sales. The firm is currently selling 300,000 units but believes as a result of the change, sales will decline to 275,000 units. On 300,000 units, sales revenue is $4,200,000, variable costs total $3,300,000, and fixed costs are $300,000. The firm has a required return on similar-risk investments of 15 percent. Evaluate this proposed change and make a recommendation to the firm.

Answer: 300,000 – 275,000 = 25,000 units decline in sales
Price = P = 4,200,000/300,000 = $14
Variable cost per unit = v = 3,300,000/300,000 = $11

Reduction in profit contribution from decline in sales
= (300,000 – 275,000 units)(14 – 11) = –$75,000

Cost of marginal investment in A/R:
Turnover of A/R with proposed plan = 360/30 = 12

$$\text{Average investment with proposed plan} = \frac{(275{,}000)(11)}{12} = \$252{,}083$$

Turnover of A/R with present plan = 360/36 = 10

$$\text{Average investment with proposed plan} = \frac{(300{,}000)(11)}{10} = \$330{,}000$$

Marginal investment in A/R = $ 77,917

Reduction in cost of marginal investment in A/R = 77,917 (0.15) = + $11,687

Reduction in marginal bad debts:
Bad debts with proposed plan = (0.012)(4,200,000) = $50,400

Bad debts with present plan = (0.008)(275,000)(14) = $30,800

Net loss from implementation of proposed plan = +$19,600
Do not recommend. –$43,713

Level of Difficulty: 4
Learning Goal: 4
Topic: Managing Credit Standards

15. Brunswick Ad Agency's accounts receivable totaled $451,000 on January 30, 2003. An aging summary of receivables at this date follows:

End of Month	Amount
January, 2003	$250,000
December, 2002	100,000
November, 2002	50,000
October, 2002	30,000
September, 2002 before	21,000
Total	$451,000

The firm extends 30-day credit terms to all its credit customers.

(a) Prepare an aging schedule for Brunswick Ad Agency.

(b) Evaluate the firm's collection performance.

Answers:

(a)

Aging Schedule				
0–30 days	**31–60**	**61–90**	**91–120**	**121 and Above**
$250,000	100,000	50,000	30,000	21,000
55%	22%	11%	7%	5%

(b) 45 percent of the firm's receivables are overdue (greater than 30 days). Improvement is needed in collections or some other area of credit policy (credit standards or credit terms).

Level of Difficulty: 3
Learning Goal: 5
Topic: Accounts Receivable Aging Schedule

16. Landrum Distributing, Inc. has completed an analysis of check-clearing times of five key suppliers. On a weekly basis, the firm has a $50,000 check disbursed to each of these suppliers, totaling $250,000. In examining the check-clearing times of each supplier, the firm revealed:

Number of Business Days for Check to Clear	Supplier
3	1
5	2
6	3
7	4
8	5

Given this information, what recommendation would you give the firm with respect to paying its suppliers weekly? Explain.

Answer:

Deposit: $50,000 on day 3 to cover Supplier 1
$50,000 on day 5 to cover Supplier 2
$50,000 on day 6 to cover Supplier 3
$50,000 on day 7 to cover Supplier 4
$50,000 on day 8 to cover Supplier 5

The financial manager should monitor clearings by calling the bank at the start of the business day.

Level of Difficulty: 3
Learning Goal: 6
Topic: Managing the Float

17. Don's Sons Company has been offered by its bank to manage its cash at a cost of $35,000 per year. Under the proposed cash management, the firm can reduce the cash required on hand by $180,000. Since the bank is also doing a lot of record keeping, the firm's administrative cost would decrease by $2,000 per month. What recommendation would you give the firm with respect to the proposed cash management assuming the firm's opportunity cost is 12 percent?

Answers:

Additional benefit from reduced required cash		
	= $180,000 × 0.12	= $21,600
Reduction in administrative costs	= $2,000 × 12	= $24,000
Total Benefit		= $45,600
Less: Cost (Bank's fee)		= $35,000
Additional benefit		= $10,600

Since benefits ($45,600) are greater than costs ($35,000), the firm should accept the proposed cash management.

Level of Difficulty: 3
Learning Goal: 6
Topic: Outsourcing Cash Management Activities

18. Match each marketable security with its description.
(a) Eurodollar deposit
(b) Banker's acceptance
(c) Federal agency issue
(d) Commercial paper
(e) Repurchase agreement
(f) Treasury bill
(g) Money market mutual fund
(h) Negotiable certificate of deposit
(i) Treasury note
1. _____ A short term, unsecured promissory note issued by a corporation.
2. _____ An obligation of the U.S. Treasury with common maturities of 91 to 182 days.
3. _____ A portfolio of marketable securities.
4. _____ An arrangement whereby a bank or securities dealer sells specific marketable securities to a firm and agrees to purchase them in the future.
5. _____ An obligation of the U.S. Treasury with mutual maturities of between one and seven years.
6. _____ Negotiable instrument evidencing the deposit of a certain number of dollars in a commercial bank.
7. _____ An instrument issued by the Federal National Mortgage Association.
8. _____ Funds deposited in banks located outside the U.S. and denominated in U.S. dollars.
9. _____ Short term credit arrangement used by businesses to finance transactions with foreign countries or firms with unknown credit capacities.

Answers:

1. (d)	2. (f)	3. (g)
4. (e)	5. (i)	6. (h)
7. (c)	8. (a)	9. (b)

Level of Difficulty: 3
Learning Goal: 6
Topic: Marketable Securities