

# ANSWER KEY

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In this section:

- Financial Literacy Pre-Test
- Financial Literacy Basics

## Financial Literacy

An overview of financial literacy and the role it plays in your business

# FINANCIAL LITERACY

## PRE-TEST



This pre-test is designed to test your current financial literacy. Please circle your answers.

1. Which of the following is a basic accounting equation?

- A. Net Worth = Assets + Profits
- B. Gross Profit – Sales = Gross Profit Margin
- C. Assets = Liabilities + Owner's Equity
- D. EBITDA = COGS – Depreciation

2. Which would you find on a Profit & Loss Statement?

- A. Depreciation
- B. Fixed Asset
- C. Accounts Payable
- D. Repayment of Debt

3. A prepaid expense is:

- A. an Asset
- B. Owner's Equity
- C. a Liability
- D. a Payable

4. Which of the following is most important to the daily operations of a business?

- A. Assets
- B. Profits
- C. Cash
- D. Sales

5. An account receivable is:

- A. an Asset
- B. Owner's Equity
- C. a Liability
- D. a Prepaid Expense

6. Which of the following items is not found on a balance sheet?

- A. Cash
- B. Sales
- C. Assets
- D. Equity

7. Which accounting system most accurately reflects profitability?
- A. Cash Accounting
  - B. Flow of Funds Accounting
  - C. Accrual Accounting
  - D. General Ledger Accounting
8. An increase in receivables is good or bad for cash.
- A. Good
  - B. Bad
  - C. Depends on the movement of your liabilities
  - D. None of the above
9. Is LIFO/FIFO a method of
- A. Inventory Evaluation
  - B. Calculating Profits
  - C. Financing
  - D. Depreciation
10. Which of the following does not affect your cash position in running a business?
- A. Lease Expense
  - B. Advertising Expense
  - C. Depreciation Expense
  - D. Interest Expense

# FINANCIAL LITERACY

## BASICS



Please go through these questions and circle the correct answer.

**1. The language of business is:**

- a. Profits
- b. Money
- c. Accounting

**ANSWER:**

- a. Profits are theories and are simply mathematical calculation of revenue less expenses.
- b. Money is simply a medium of exchange.
- c. **CORRECT.** Accounting tells the story of management decisions, how those decisions were executed and translate those activities into numbers.

**2. There are three scorecards that will tell you how well the business is doing and they are:**

- a. Profit & Loss Statement & Statement of Operations
- b. Profit & Loss Statement, Balance Sheet, Cash Statement
- c. Balance Sheet, Statement of Position, Cash Statement

**ANSWER:**

- a. Profit & Loss Statement & Statement of Operations are the same.
- b. **CORRECT.**
- c. Balance Sheet and Statement of Position are the same.

**3. Every transaction affects the Balance Sheet. Another name for Balance Sheet is the Statement of Position. We could also say that it is the:**

- a. Road map
- b. City map
- c. World Atlas

**ANSWER:**

- a. The Balance Sheet provides an overall “big picture” snapshot.
- b. See a.
- c. **CORRECT.** A Balance Sheet does not show all the details of how Cash and Net Income were created, but it does show the ending numbers.

**4. The Balance Sheet is made up of three sections:**

- a. Things and stuff, what we owe and what we own.
- b. Assets, Liabilities and Owner's Equity
- c. Both of the above

**ANSWER:**

- a. True
- b. True
- c. CORRECT

**5. Assets are defined as:**

- a. Mortgages, accounts payable.
- b. Things and stuff with future economic value
- c. What the shareholders have invested and the earnings retained in the business

**ANSWER:**

- a. Mortgages and accounts payable both represent what we owe and are part of liabilities.
- b. CORRECT.
- c. This is the definition of Shareholder's Equity

**6. Liabilities are:**

- a. Defined as what the business owes.
- b. Items such as bank loans, notes payable, mortgages
- c. Both of the above

**ANSWER:**

- a. True
- b. True
- c. CORRECT.

**7. Owner's Equity is defined as:**

- a. The Shareholders investment
- b. The difference between assets and liabilities
- c. Both of the above

**ANSWER:**

- a. This is an incomplete definition since it does not include the earnings which have been retained in the business. A business owns its earnings
- b. CORRECT.
- c. See a.

**8. When people receive their financial statements for their business or investments, they usually start to drink. Why?**

- a. They haven't received the Statement of Cash Flows.
- b. They are so frustrated because they don't have a clue what the financial statements are saying or how to read them.
- c. They are thirsty and feel the need to have a blinding headache the next day.
- d. They look only at the Net Income figure and if it's good, they celebrate and if it's bad they drown their sorrows.

**ANSWER:**

- a. Most people don't have a clue what a Statement of Cash Flow is so this would hardly qualify as a reason to drink.
- b. While this is true, it isn't the number one reason why people drink.
- c. This is also true, except for the part about headaches
- d. **CORRECT.** 98% of all business owners and investors believe that Net Income is real. Net Income is a theory, Cash is a fact.

**9. The Profit & Loss Statement really tells a business:**

- a. How good the management is at controlling expenses.
- b. How good the management is at converting revenue into assets.
- c. How good the management is at converting revenue into cash.

**ANSWER:**

- a. **CORRECT.** Assets are converted into Revenue and Revenue is converted into Net Income. Net Income is simply how much the Revenue has been converted into Net Income, or how good the management is at controlling expenses.
- b. Assets are not part of the Profit & Loss Statement.
- c. Cash does not appear on a Profit & Loss Statement. Cash is found on the Cash Statements and Balance Sheet.

**10. Drinking when you get the Profit & Loss Statement may or may not be justified. The problem is that we can't be sure just by looking at it. What we really to look at is:**

- a. Liabilities
- b. Cash Statement
- c. Owner's Equity

**ANSWER:**

- a. This may or may not be a reason to drink. We would need more information.
- b. **CORRECT.** Cash is a fact, while Net Income is the theory of how much revenue exceeded the expenses. Net Income is NOT Cash.
- c. This may or may not be a reason to drink. We would need more information.

**11. The Cash Statement (Statement of Cash Flows) is summarized in the Balanced Sheet. In the Balanced Sheet, Cash is:**

- a. Beginning Cash for the period.
- b. Ending Cash as of the date of the Balance Sheet.
- c. The amount of theoretical cash you would have if you collected all your receivables and paid of all your liabilities.

**ANSWER:**

- a. The Balance Sheet is a snapshot of what things look like at a certain point in time. Cash on the Balance Sheet is the actual amount of Cash as of the date on the Balance Sheet. i.e. Ending Cash
- b. CORRECT.
- c. See a above

**12. Cash for the business, as shown on the Cash Statement, can come from or go to:**

- a. One of two sources
- b. One of three sources
- c. Only one source

**ANSWER:**

- a. Cash can come from or be used for Operations, Investments or Financing
- b. CORRECT.
- c. See a above

**13. Although any type of Cash is good, one type is far more important than any of the others:**

- a. Operating Cash
- b. Investing Cash
- c. Financing Cash

**ANSWER:**

- a. CORRECT. Operating Cash shows how well the management is doing at converting Net Income into Cash.
- b. Investing Cash is about buying or selling Assets.
- c. Financing Cash shows how much money has been raised from shareholders or borrowed/repaid to lenders

**14. The final total for Operation Cash:**

- a. Can only be positive
- b. Can only be negative
- c. Can either be positive or negative

**ANSWER:**

- a. Not true. A business can lose cash during a period because their receivables grow or they purchase a lot of inventory or they pay down their payables. Operating Cash could also be negative because the cash operating expenses of the business exceeded the cash collected from sales and receivables.
- b. See a Above.
- c. CORRECT.

15. Cash is generated from financing activities when money is raised from the shareholders or is borrowed from the bank.

- a. True
- b. False

ANSWER:

- a. CORRECT.
- b. Selling a part of the business (shares) is one of the most common methods of starting a business. Money borrowed from a bank is a financing mechanism for growing a business.

16. Cash is reduced when money is paid to the shareholders in the form of dividends.

- a. True
- b. False

ANSWER:

- a. CORRECT.
- b. Cash is reduced and so is Owner's Equity (Retained Earnings) because the business has paid out in cash from some of the earnings it had previously accumulated.

17. Net income is theory, and Cash is a fact. Some business owners make the mistake of believing that Net Income is the same as \_\_\_\_\_.

ANSWER:

Cash.  
On paper you can have a great net income but until it is converted to cash, it is still just a theory.

18. Net profit and cash have \_\_\_\_\_ to do with one another.

- a. Everything
- b. Nothing

ANSWER:

- a. Net Profit is only a theory until it is converted to cash.
- b. CORRECT. Cash can be used or generated by Operations, or by investing activities or by Financing. Investing and Financing activities have nothing whatsoever to do with Net Income.

**19. If your goal is to increase your net income then:**

- a. You could concentrate on increasing revenue.
- b. You could concentrate on decreasing expenses.
- c. You could do both.

**ANSWER:**

- a. This would definitely help. However, it would help even more if; at the same time you will try to decrease the expenses. Expenses are usually the low hanging fruit.
- b. Same as a.
- c. CORRECT.

**20. Depreciation is the amount the government allows you to write off against the historical cost of an asset based on its projected life span.**

- a. True
- b. False

**ANSWER:**

- a. CORRECT.
- b. The government allows businesses to partially recover, over time, the original cost of an asset in this manner.

**21. A vehicle is purchased for \$10,000. It has a useable expected life span of five years and zero expected residual value. The amount of depreciation expense your business could write off each year would be:**

- a. \$1000
- b. \$5000
- c. \$2000

**ANSWER:**

- a. \$10,000 divided by 5 years = \$2000. Asset cost divided by life span = annual depreciation expense
- b. Same as a.
- c. CORRECT.

**22. Depreciation is a cash expense.**

- a. True
- b. False

**ANSWER:**

- a. Depreciation is a non-cash expense. Cash might have been spent at the time of purchase, but the depreciation expense is an annual adjustment to reduce the value of an asset (on the Balance Sheet) based on the assets' estimated life span.
- b. CORRECT.

23. The only fixed asset which is normally not depreciated is \_\_\_\_\_.

ANSWER:

Land.

Vehicles, equipment and buildings are all normally depreciated. An exception to land would be if it was purchased as a mine, gravel pit or timber – something where the useful life of the land would decrease each year.

24. As expenses go, depreciation is a good expense for a business because it's an expense which does not lower your cash but does lower your earnings and therefore your \_\_\_\_\_.

ANSWER:

Taxes. All expenses reduce Net Income and thus, lower taxes. Since depreciation is a non-cash expense, the business receives the benefit of lower taxes, but does not incur the cash expense of depreciation, only the cash outlay or the asset purchased. In effect, the government has helped pay for the asset by the % of tax bracket of the business.

25. The Cost of Goods Sold is a major expense affecting net income calculations for all the following businesses except:

- a. Manufacturing
- b. Distribution
- c. Service

ANSWER:

- a. COGS is found only in businesses that have inventory. Manufacturing and Distribution businesses have inventory and thus have high Cost of Goods Sold.
- b. See a above.
- c. CORRECT. Service companies usually are selling time and not raw materials or inventory and therefore usually do not have a COGS number on the Profit & Loss Statement.

26. Cost of Goods Sold was inventory prior to being sold, so anything that changes the inventory would also affect your:

- a. Bank Statement
- b. Balance Sheet
- c. Profit & Loss Statement
- d. B and C

ANSWER:

- a. Bank Statement merely tells the business how the cash was spent, how much cash is in the bank and has nothing to do with the inventory.
- b. Yes.
- c. Yes.
- d. CORRECT.

27. Revenue minus COGS = \_\_\_\_\_.

- a. Gross Profit
- b. Net Profit
- c. Gross Revenue

ANSWER:

- a. CORRECT. The profit after COGS, but before all other operating expenses.
- b. Net Profit would be Revenue-COGS-Expenses.
- c. Gross Revenue is the same as Sales or Turnover.

28. Gross Profit minus \_\_\_\_\_ Expenses=EBITDA

ANSWER:

Operating.

29. EBITDA stands for Earnings Before Interest, Taxes, Depreciation and Amortization. It is the pre-tax earnings of the business before:

- a. Cash Expenses
- b. Inventory costs
- c. The cost of financing and asset related expenses.

ANSWER:

- a. EBITDA is found on a Profit & Loss Statement and therefore cash in non-event.
- b. The cost of inventory sold is accounted for in the COGS line, which is a deduction for purposes of calculating EBITDA.
- c. CORRECT. EBITDA is a useful, although imperfect way to compare the operating components of different businesses and ignore financing, asset related charges and income tax rates.

30. Bad debts are accounted for as:

- a. An Asset
- b. An expense
- c. A liability

ANSWER:

- a. Assets are the things and stuff which have future economic value on the Balance Sheet. Clearly, someone not paying you what they owe is not an asset.
- b. CORRECT. An expense is a cost of doing business and reduces the net income or earnings of the business.
- c. A liability is a debt or an amount owed to someone else.

31. Profit can be defined in many ways. We could say it is by how much your sales exceed expenses. We could also say it indicates how efficient you are at controlling expenses.

- a. True
- b. False

ANSWER:

- a. CORRECT.
- b. Revenue – Expenses = Net Income (Profits, Earnings)

32. When a transaction occurs, we know it must be recognized on the Profit & Loss Statement if the transaction increases or decreases.

- a. Accounts Payable
- b. Earnings
- c. Assets
- d. All of the above

ANSWER:

- a. The Profit & Loss Statement records any transaction which either Increases or reduces Net Income. Therefore, all revenue and all expenses (costs of producing that revenue) are recorded on the Profit & Loss Statement. Accounts payable can be increased or decreased and not impact the Profit & Loss Statement.
- b. CORRECT.
- c. See a above.
- d. See a above.

33. Label the missing items below:

BALANCE SHEET

A.	B.
	C.

ANSWER:

- a. Assets.
- b. Liabilities
- c. Owner's Equity

34. Label the following:

O _____
I _____
F _____

**ANSWER:**

Operating  
Investing  
Financing

**35. An increase in receivables is good or bad for cash.**

**ANSWER:**

Bad – the more money customers owe you, the less cash you have to run the business.

**36. An increase in inventory is good/bad for cash**

**ANSWER:**

Bad – the more money you tied up in inventory, the less cash you have to run the business.

**37. An increase in payables is good/bad for cash**

**ANSWER:**

Good - the more money you owe, the more cash you have to pay for other things.

**38. Therefore, Operating Cash is affected by the level of:**

- a. Receivables
- b. Inventory
- c. Payables
- d. All of the above.

**ANSWER:**

d. CORRECT

**39. If you are attempting to determine the financial health of a business, remember that the COGS were \_\_\_\_\_ first. A company in trouble may find this a good place to hide problem expenses and thus increase profits.**

**ANSWER:**

Inventory

**40. Let's check your understanding of the relationship of the various score cards. Every transaction affects the:**

- a. Balance Sheet
- b. Profit & Loss Statement
- c. Cash Statement

**ANSWER:**

- a. CORRECT.
- b. INCORRECT. In Accrual Accounting, many transactions have zero impact on a Profit & Loss Statement. e.g buying a new printer on credit or purchasing inventory
- c. Many transactions occur without involving cash.

**41. When Operating Cash is used on the Balance Sheet, it is a result of an increase in:**

- a. Accounts Receivable
- b. Goodwill
- c. Shareholder's Equity
- d. Plant and Equipment
- e. All of the above

**ANSWER:**

- a. CORRECT. An increase in Accounts Receivable uses Cash.
- b. Goodwill arises when assets are purchased for more than their Value
- c. Shareholder's Equity is not cash
- d. Property, Plant and Equipment uses Investing Cash.
- e. See b, c, d above

**42. When Investment Cash is used on the Balance Sheet, it is a result of an increase in:**

- a. Accounts Payable
- b. Accounts Receivable
- c. Inventory
- d. Plant and Equipment
- e. All of the above

**ANSR:**

- a. Accounts Payable is a Liability. An increase in Accounts Payable would result in an increase in Operating Cash.
- b. Accounts Receivable uses Operating Cash
- c. Inventory uses Operating Cash
- d. CORRECT
- e. See a, b, c above

**43. When Financing Cash is used on the Balance Sheet, it is a result of a decrease in:**

- a. Accounts Payable
- b. Earnings
- c. Goodwill
- d. Debt Outstanding
- e. All of the above

**ANSWER:**

- a. Accounts Payable is Operating Cash.
- b. Earnings are not cash.
- c. Goodwill is not cash.
- d. CORRECT. Paying back debt uses Financing Cash as does paying a dividend, which also reduces Retained Earnings
- e. See a, b, c above

44. The final figure on the Profit & Loss Statement is Net Income. That figure appears on the Balance Sheet as:

- a. Retained Earnings
- b. Cash
- c. Goodwill
- d. Earnings \_\_\_\_\_ (Year to Date or Month or Quarter or Fiscal Year Ending XX/YY)
- e. Common Stock

ANSWER:

- a. Retained Earnings are the total, cumulative profits of the business which have been retained in the business since the business began.
- b. Cash has nothing to do with Net Profits
- c. Goodwill arises when assets are purchased for more than their Value
- d. CORRECT. Net Profit for the current period is found in the Owner's Equity section on the Balance Sheet in a category called Earnings.
- e. Common Stock represents the money invested in the business by the shareholders.

45. A Balance Sheet is a:

- a. Movie
- b. A DVD
- c. A Snapshot in time

ANSWER:

- a. INCORRECT. A Profit & Loss Statement and a Cash Statement have a beginning and an end, so they are like a movie. They tell the story of what happened over time.
- b. See an above.
- c. CORRECT. Balance Sheets show what the business looks like at an exact moment in time.

46. A Profit & Loss Statement and a Cash Statement have a beginning and an end and that shows what happens over a period of time. They are more like a \_\_\_\_\_ than a snapshot.

ANSWER:

Movie/Video

47. Earnings the business chooses to keep and not pay out in Dividends are called \_\_\_\_\_ Earnings on the Balance Sheet.

ANSWER:

Retained

48. Earnings the business chooses to pay out or distribute to shareholders (owners) are called \_\_\_\_\_.

ANSWER:

Dividends

49. All transaction come in two parts:

- a. Male and Female
- b. Right and Wrong
- c. Good and Bad
- d. The Promise and the Settlement

ANSWER:

d. CORRECT. In business, most transactions do not settle in cash immediately. The Income records the Promise and the Cash Statement records the Settlement.

50. In business, Management makes Decisions which result in Activities which then appear on the score card as \_\_\_\_\_.

ANSWER:

Numbers

51. FIFO stands for \_\_\_\_\_.

ANSWER:

First In First Out

52. LIFO stands for \_\_\_\_\_.

ANSWER:

Last In First Out

53. Both FIFO and LIFO are different systems to account for \_\_\_\_\_.

ANSWER:

Inventory

54. When inventory prices are going up and the goal of business is to maximize earnings, the best Inventory accounting method to use would be \_\_\_\_\_.

ANSWER:

FIFO

55. LIFO is high COGS if inventory prices are going up so using LIFO would result in \_\_\_\_\_ (higher or lower) net profit?

ANSWER:

Lower