Assessment

Understanding Financial Statements

Third Edition

Complete this book, and you'll know how to:

1) Describe how financial statements are prepared and what each statement means to a business
2) Calculate and use ratios to measure a business's financial operation
3) Apply ratio analysis to better understand your business operation and make more effective decisions
4) Explain fixed and variable costs and describe how they relate to profitability
5) Apply proven techniques for gaining better control over your business finances

Assessment Questions for *Understanding Financial Statements*, *Third Edition*

Select the best response.

1. What are financial statements?
    A. A measure of the activity of a business
    B. A way to report taxable activity
    C. Documents needed by your banker
    D. All of the above
2. What is the primary function of the income statement?
    A. To show the financial status of the business at a moment in time
    B. To measure the performance of the business over time
    C. To forecast cash inflows and outflows
    D. None of the above
3. What are accruals?
    A. Money someone owes the business
    B. Inventories
    C. Expenses that have not been paid
    D. All of the above
4. Who uses financial statements?
    A. Accountants
    B. Bankers
    C. Owners
    D. Managers
    E. All of the above
5. What is the primary function of the balance sheet?
    A. To show the financial status of the business at a moment in time
    B. To measure the performance of the business over time
    C. To forecast cash inflows and outflows
    D. None of the above

6. What determines whether the business can pay its bills?
   A. It is profitable.
   B. It has accounts receivable.
   C. It has positive cash flow.
   D. None of the above.
7. What is the primary function of the cash flow statement?
   A. To show the financial status of the business at a moment in time
   B. To measure the performance of the business over time
   C. To forecast cash inflows and outflows
   D. None of the above
8. What determines whether a business is a good investment?
   A. It has a positive net worth.
   B. It is profitable over time.
   C. It has a positive cash flow.
   D. All of the above.
9. Net worth and market value are the same thing.
   A. True
   B. False
10. What is the most important item on any of the financial statements?
    A. Net worth
    B. Cash flow
    C. Accounts payable
    D. Furniture and fixtures
    E. None of the above
11. What is a ratio?
    A. A financial statement
    B. A percentage or proportion of one number to another
    C. A decision rule that must be followed in managing the business
12. Working capital is:
    A. Current assets minus current liabilities
    B. Net profit
    C. Cash
    D. Accounts receivable

13. Liquidity ratios measure:
    A. How much money the business is making
    B. The business's ability to meet current obligations
    C. How well you are running the business
    D. The price of stock

14. The debt-to-equity ratio shows the relative proportion of the company financed by loans and/or other creditors.
    A. True
    B. False

15. The average collection period shows:
    A. Inventory turnover
    B. The time customers take to pay for merchandise on credit
    C. The relationship of price to earnings

16. Profitability ratios measure:
    A. How much money the business is making
    B. The business's ability to meet current obligations
    C. How well you are running the business
    D. The price of stock

17. The rate of return on sales is the same as net profit.
    A. True
    B. False

18. Efficiency ratios measure:
    A. How much money the business is making
    B. The business's ability to meet current obligations
    C. How well you are running the business
    D. The price of stock

19. Inventory turnover shows:
    A. Total liabilities and net worth
    B. Net profit before taxes
    C. The number of times that inventory is replaced during the year

20. What is the value of using ratios for a business manager?
    A. None—they are valuable only to accountants.
    B. They tell you what to do.
    C. They facilitate comparison of similar situations with different numbers.

21. If your ratios deviate significantly from the industry averages:
    A. You are in very deep trouble.
    B. You should check the areas where your ratios are different.
    C. It doesn't mean anything.
    D. It is a good sign.

22. If your current ratio is higher than the industry average:
    A. You should check your debt, savings, inventory, etc., to see that your money is working for you.
    B. You should check inventory, accounts receivable, and debt structure to see how you can improve your liquidity.

23. If your turnover-of-cash ratio is higher than the industry average:
    A. You might not have enough liquidity in your operation
    B. You might have too much liquidity in your operation

24. If your debt-to-equity ratio is lower than the industry average:
    A. You might be able to use more leverage to improve your operation.
    B. You might be over-trading, or using too much debt.

25. If your rate of return on sales ratio is higher than the industry average:
    A. You are doing worse than the average.
    B. You are doing better than the average.

26. The debt-to-equity ratio expresses the relationship between capital contributed by creditors and capital contributed by owners.
    A. True
    B. False

27. If your accounts-receivable to net-sales ratio is higher than the average, you should:
    A. Increase sales.
    B. Decrease fixed expenses.
    C. Increase collection efforts.
    D. Reduce inventory turnover.

28. Ratios will vary depending on your business's age, the time in the business cycle, the economic conditions, and your type of business.
    A. True
    B. False

29. You determine the rate of return on sales by:
    A. Dividing operating income by net sales
    B. Dividing net sales by fixed assets
    C. Dividing income before taxes by net worth
    D. Dividing total debt by net worth
30. Industry ratios represent iron-clad standards that all businesses must meet.
    A. True
    B. False
31. All expenses vary directly with sales volume.
    A. True
    B. False
32. Breakeven is calculated as follows:
    A. Sales divided by net worth
    B. Fixed costs plus variable costs
    C. Average age of receivables
    D. Amount of inventory turnover
33. Overhead expenses are:
    A. Fixed costs
    B. Variable costs
34. Lowering your price will increase sales:
    A. Always
    B. Sometimes
    C. Never
35. Expenses represent profits that you don't get to keep.
    A. True
    B. False
36. Profit is a function of:
    A. Net worth
    B. Debt to worth
    C. Sales minus expenses
    D. Working capital
37. The cost of goods sold is the price paid for products that are sold or the costs of producing them.
    A. True
    B. False

38. Profit and cash flow are the same.
    A. True
    B. False

39. Fixed expenses are fixed, so you cannot change them.
    A. True
    B. False

40. An increase in sales will always result in an increase in profits.
    A. True
    B. False

41. Trend analysis is both a tracking tool and a planning tool.
    A. True
    B. False

42. Cash flow forecasting is based on:
    A. Current assets minus current liabilities
    B. Net worth
    C. Cash in minus cash out
    D. Accounts receivable

43. Target statements are historical accounting reports.
    A. True
    B. False

44. Accounts receivable aging is based on:
    A. Inventory
    B. Sales
    C. Customer billings
    D. Fixed assets

45. Net profit is based on:
    A. Sales minus CGS and operating expenses
    B. Accounts receivable
    C. Current assets minus current liabilities

46. The inventory turnover ratio measures
    A. Net sales/Fixed assets
    B. Net sales/Working capital
    C. Operating income/Net sales
    D. CGS/Average inventory

47. If an account is past due more than 6 months, the likelihood of collection is about:
    A. 10%
    B. 25%
    C. 50%
    D. 80%

48. Any use of ratios must take into account:
    A. The economy
    B. The business cycle
    C. The age of the business
    D. The area of the country where the business is located
    E. All of the above

49. The average collection period is calculated by:
    A. Dividing total accounts receivable by 365
    B. Multiplying total accounts receivable by 365 days, and then dividing that number by credit sales
    C. Dividing net sales by accounts receivable

50. Net income from sales should be about:
    A. 2%
    B. 4%
    C. 6%
    D. 10%

Assessment Answer Key for
Understanding Financial Statements, *Third Edition*

Recommended response (Corresponding Part)

1. D (9)
2. B (10)
3. C (12)
4. E (9)
5. A (11)
6. C (24)
7. C (25)
8. D (28)
9. B (20)
10. B (25)
11. B (32)
12. A (38)
13. B (34)
14. A (40)
15. B (52)
16. A (43)
17. A (44)
18. C (51)
19. C (54)
20. C (31)
21. B (69)
22. A (70)
23. A (70)
24. A (70)
25. B (70)
26. A (40)
27. C (71)
28. A (71)
29. A (44)
30. B (69)
31. B (77)
32. B (78)
33. B (77)
34. B (76)
35. A (82)
36. C (78)
37. A (21)
38. B (95)
39. B (77)
40. B (76)
41. A (86)
42. C (95)
43. B (103)
44. C (106)
45. A (23)
46. D (46)
47. C (106)
48. E (64)
49. B (68)
50. D (44)