

## Financial Accounting

### Financial Statements and Analysis Quiz – Answer Key

1. **(B) Assets = Liabilities + Equity.** This fundamental equation must always balance. Assets are what the company owns; liabilities and equity represent how assets are financed.
2. **(B) Balance Sheet.** The balance sheet shows assets, liabilities, and equity at a specific date. Income statement and cash flow statement cover periods of time.
3. **(B) Allocate the cost of an asset over its useful life.** Depreciation matches the expense of using an asset to the revenues it generates (matching principle). It's a non-cash expense.
4. **(B) Liquidity.** Current ratio = Current Assets / Current Liabilities. It measures ability to pay short-term obligations. Values above 1 indicate sufficient short-term resources.
5. **(C) The earnings process is substantially complete and collection is reasonably assured.** Revenue recognition under accrual accounting follows the realization principle, not cash receipt timing.
6. **False.** An increase in accounts receivable means sales were made but cash wasn't collected—it's a use of cash (subtracted in operating activities under indirect method).
7. **True.** LIFO assigns newer (higher) costs to COGS during inflation, resulting in higher expenses and lower net income compared to FIFO, which assigns older (lower) costs.
8. **True.** Goodwill = Purchase Price - Fair Value of Net Identifiable Assets. It represents intangibles like brand value, customer relationships, and synergies.

#### **9. Income Statement:**

- Reports financial performance over a period
- Shows revenues, expenses, and net income
- Answers: "How profitable was the company?"
- Key items: Revenue, COGS, Operating Expenses, Net Income

#### **Balance Sheet:**

- Reports financial position at a point in time
- Shows assets, liabilities, and equity
- Answers: "What does the company own and owe?"
- Must balance: Assets = Liabilities + Equity

#### **Cash Flow Statement:**

- Reports cash movements over a period
- Three sections: Operating, Investing, Financing activities
- Answers: "Where did cash come from and go?"

- Reconciles net income to cash changes

#### **Interconnections:**

- Net income (Income Statement) → flows to Retained Earnings (Balance Sheet)
- Net income → starting point for operating cash flow (Cash Flow Statement)
- Ending cash (Cash Flow Statement) → Cash asset (Balance Sheet)
- Retained Earnings connects all three statements

#### **10. Cash Basis Accounting:**

- Records revenue when cash received
- Records expenses when cash paid
- Simple but doesn't match economic activity
- Example: December service, January payment → revenue in January

#### **Accrual Basis Accounting:**

- Records revenue when earned (regardless of cash receipt)
- Records expenses when incurred (regardless of payment)
- Matches revenues with related expenses
- Example: December service, January payment → revenue in December

#### **Why GAAP/IFRS require accrual:**

- Better matches economic reality
- Enables meaningful period-to-period comparisons
- Prevents manipulation through payment timing
- Provides more relevant information for decision-making
- Supports the matching principle

#### **Examples:**

- *Accounts Receivable:* Under accrual, credit sales recorded as revenue immediately; cash basis waits for payment
- *Prepaid Insurance:* Under accrual, expensed monthly as coverage used; cash basis records full expense when paid
- *Accrued Wages:* Under accrual, expense recorded as employees work; cash basis records only when paid