THE 10 LAWS OF FINANCE

A Real-World Education in Money, Business, and Freedom

STUDY GUIDE & WORKBOOK

Law 2: Displaying Wealth Consumes It

About This Workbook

This study guide accompanies Law 2 and covers the critical distinction between the appearance of success and economic reality. You will learn to analyze financial statements, understand the difference between accrual and cash accounting, and apply professional skepticism to both business analysis and personal finance decisions.

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From Sleeping in a Car to Advising Billion-Dollar Deals

San José State University | Finance 170

PART ONE: MULTIPLE-CHOICE EXAMINATION

Questions are organized by learning objective. Each section builds on the previous, progressing from foundational concepts to advanced application.

Learning Objective 1: The Functions of Financial Statements

1. Which financial statement reports a company's financial position at a specific point in time, adhering to the equation Assets = Liabilities + Equity?

- **A.** Statement of Cash Flows
- **B.** Statement of Financial Position (Balance Sheet)
- **C.** Income Statement
- **D.** Statement of Retained Earnings

2. The primary purpose of the Income Statement is to measure:

- **A.** The total cash generated by the business over a period.
- **B.** The solvency of the business at a specific date.
- **C.** The financial performance (profitability) over a specific period.
- **D.** The value of assets owned by the shareholders.

3. Which financial statement is designed to reconcile Net Income with the actual changes in cash and cash equivalents?

- **A.** The Balance Sheet
- **B.** The Statement of Comprehensive Income
- **C.** The Statement of Cash Flows
- **D.** The Statement of Shareholders' Equity

4. In the context of financial analysis, "Equity" represents:

- **A.** The amount of cash the company has in the bank.
- **B.** The residual interest in the assets of the entity after deducting liabilities.
- **C.** The total revenue generated since inception.
- **D.** The external debts owed to creditors.

Learning Objective 2: Accrual vs. Cash Accounting

5. The Income Statement is prepared using Accrual Accounting. This means that:

- **A.** Revenue is recorded when cash is received, and expenses are recorded when paid.
- **B.** Revenue is recorded when earned, and expenses are recorded when incurred, regardless of cash flow.

C. Revenue and expenses are only recorded at the end of the fiscal year.

D. Expenses are never recorded until the liability is fully settled.

6. A company delivers a product to a customer in January but receives payment in March. Under accrual accounting, when is the revenue recognized?

A. January

B. February

C. March

D. Pro-rated across all three months

7. Which of the following best describes the relationship between Net Income and Operating Cash Flow?

A. They will always be the same number.

B. Net Income includes non-cash items (like depreciation) and accruals, whereas Operating Cash Flow adjusts for these to show actual liquidity.

C. Net Income is a measure of liquidity, while Operating Cash Flow is a measure of profitability.

D. Operating Cash Flow flows into the Income Statement to determine Net Income.

Learning Objective 3: Financial Statement Articulation

8. How does Net Income from the Income Statement articulate (connect) with the Balance Sheet?

- **A.** It is added to the Cash balance.
- **B.** It is added to Retained Earnings within Shareholders' Equity.
- **C.** It is subtracted from Total Liabilities.
- **D.** It is recorded as an Asset called "Goodwill."

9. Which specific line item links the bottom of the Statement of Cash Flows to the Balance Sheet?

- **A.** Net Income
- **B.** Total Operating Expenses
- **C.** Ending Cash and Cash Equivalents
- **D.** Total Investing Activities

10. If a company reports positive Net Income but its Retained Earnings do not increase, which of the following has most likely occurred?

- **A.** The company issued new debt.
- **B.** The company declared and paid dividends to shareholders.
- **C.** The company purchased new equipment (CapEx).
- **D.** The company had high depreciation expenses.

Learning Objective 4: Transaction Analysis (Quantitative)

Scenario for Questions 11–14

A consulting firm completes a project for a client on September 15 and invoices the client for $10,000. The client pays the full amount on October 15.

11. What is the impact on the firm's September Income Statement?

- **A.** Revenue increases by $10,000; Net Income increases.
- **B.** Revenue is $0; Net Income is $0.
- **C.** Revenue increases by $10,000; Net Income remains unchanged.
- **D.** Expenses increase by $10,000.

12. What is the impact on the firm's September Balance Sheet?

- **A.** Cash increases by $10,000.
- **B.** Accounts Receivable increases by $10,000; Retained Earnings increases by $10,000.

- **C.** Liabilities increase by $10,000.
- **D.** No changes are recorded until cash is received.

13. What is the impact on the firm's September Statement of Cash Flows?

- **A.** Operating Cash Flow increases by $10,000.
- **B.** Financing Cash Flow increases by $10,000.
- **C.** Investing Cash Flow decreases by $10,000.
- **D.** There is no impact on Cash Flow.

14. When the cash is received in October, how is the Balance Sheet adjusted?

- **A.** Cash increases by $10,000; Revenue increases by $10,000.
- **B.** Cash increases by $10,000; Accounts Payable decreases by $10,000.
- **C.** Cash increases by $10,000; Accounts Receivable decreases by $10,000.
- **D.** Retained Earnings increases by $10,000.

Learning Objective 5: Financial Interpretation & Terminology

15. Which Balance Sheet account represents obligations owed to suppliers for goods or services received but not yet paid for?

- **A.** Accounts Receivable
- **B.** Prepaid Expenses
- **C.** Accounts Payable
- **D.** Unearned Revenue

16. Which Income Statement metric represents Revenue minus the Cost of Goods Sold (COGS)?

- **A.** Operating Income (EBIT)
- **B.** Gross Profit
- **C.** Net Income
- **D.** EBITDA

17. A company purchases a new factory for $1,000,000 using cash. In which section of the Statement of Cash Flows will this outflow appear?

- **A.** Operating Activities
- **B.** Investing Activities
- **C.** Financing Activities
- **D.** This transaction does not appear on the Cash Flow Statement.

18. What is the primary risk for a "Profitable but Illiquid" company?

- **A.** It cannot generate sales.
- **B.** It has too much debt relative to equity.
- **C.** It generates Net Income but lacks sufficient cash to meet immediate obligations (Solvency Risk).
- **D.** It has negative Gross Margins.

19. Company A recognizes $50,000 in Revenue in Month 1. The associated expenses are $30,000 (paid immediately). The customer does not pay until Month 3. What is the Net Income and Operating Cash Flow for Month 1?

- **A.** Net Income: $20,000 | Operating Cash Flow: $20,000
- **B.** Net Income: $20,000 | Operating Cash Flow: ($30,000)
- **C.** Net Income: $0 | Operating Cash Flow: ($30,000)
- **D.** Net Income: $50,000 | Operating Cash Flow: $0

20. Which ratio is commonly derived from the Income Statement to measure the efficiency of core operations before interest and taxes?

- **A.** Return on Assets (ROA)
- **B.** Operating Margin (Operating Income / Revenue)

C. Current Ratio
D. Debt-to-Equity Ratio

PART ONE: ANSWER KEY

Quick Reference

Q	Ans	Q	Ans	Q	Ans
1	**B**	8	**B**	15	**C**
2	**C**	9	**C**	16	**B**
3	**C**	10	**B**	17	**B**
4	**B**	11	**A**	18	**C**
5	**B**	12	**B**	19	**B**
6	**A**	13	**D**	20	**B**
7	**B**	14	**C**		

Detailed Rationale

1. B — The Balance Sheet is the snapshot of position.

The Balance Sheet (Statement of Financial Position) reports assets, liabilities, and equity at a specific point in time, adhering to the fundamental equation.

2. C — The Income Statement measures performance/profitability.

Unlike the Balance Sheet's point-in-time view, the Income Statement covers a period and shows how effectively the company generated profit.

3. C — The Cash Flow Statement reconciles accruals to cash.

The Statement of Cash Flows bridges the gap between accrual-based Net Income and actual cash movements.

4. B — Equity is the residual interest: Assets – Liabilities.

Equity represents what remains for owners after all obligations are satisfied. It's what you truly own.

5. B — Accrual accounting records economic activity regardless of cash timing.

This is the fundamental difference from cash accounting. Revenue is recognized when earned, expenses when incurred.

6. A — Revenue is recognized when the performance obligation is satisfied.

The product was delivered in January, so the revenue is earned in January—even though cash arrives later.

7. B — Net Income is an accounting construct; Cash Flow adjusts for non-cash items.

Depreciation, accrued revenues, and prepaid expenses all create differences between profit and actual cash.

8. B — Net Income increases Retained Earnings.

This is the key articulation point: profits flow to the Balance Sheet through Retained Earnings, increasing owner equity.

9. C — The Ending Cash on the Cash Flow Statement matches Cash on the Balance Sheet.

This is how the statements "tie out"—the cash balance must match between the two statements.

10. B — Dividends reduce Retained Earnings even if Net Income is positive.

If a company earns $100 and pays $100 in dividends, Retained Earnings stays flat despite being profitable.

11. A — Revenue is recognized upon completion of work.

Under accrual accounting, completing the project triggers revenue recognition, which increases Net Income.

12. B — An asset, Accounts Receivable, is created.

The debit is to A/R (asset), the credit is to Revenue, which flows through to Retained Earnings (equity).

13. D — No cash has changed hands yet.

The Cash Flow Statement only reflects actual cash movements. No cash = no impact on this statement.

14. C — Asset swap: One asset (Cash) replaces another (Receivable).

When cash is collected, A/R decreases and Cash increases. No new revenue—that was already recognized.

15. C — Accounts Payable.

A/P represents amounts owed to suppliers. A/R is money owed TO you. Don't confuse them.

16. B — Gross Profit.

Gross Profit = Revenue – COGS. It measures production efficiency before operating expenses.

17. B — Purchase of long-term assets is an Investing Activity.

CapEx (buying factories, equipment, etc.) flows through the Investing section of the Cash Flow Statement.

18. C — Profitability does not guarantee liquidity/solvency.

A company can be profitable on paper but run out of cash to pay bills. This is the "profitable but illiquid" trap.

19. B — Profit: $20k (Revenue $50k – Expenses $30k). Cash Flow: ($30k) (Inflow $0 – Outflow $30k).

This question tests the core disconnect between accrual profit and cash reality. You can be profitable and cash-negative simultaneously.

20. B — Operating Margin measures core efficiency.

Operating Margin (EBIT/Revenue) shows how efficiently the core business generates profit before financing costs.

PART TWO: QUANTIATIVE QUESTIONS

1. At the end of the fiscal year, "San Jose Consulting" has: Total Assets of $750,000 and Total Liabilities of $400,000. Using the accounting equation, what is the value of Shareholders' Equity?

A. $1,150,000
B. $350,000
C. $400,000
D. $750,000

2. A software firm completes a $20,000 contract in December 2025. The client is invoiced immediately but pays the full amount in February 2026. Under accrual accounting, how much revenue should be reported on the 2025 Income Statement?

A. $0
B. $10,000
C. $20,000
D. $6,666

3. "The Pizza Press" reports the following for the month: Revenue: $100,000; Cost of Goods Sold (COGS): $40,000; Rent and Utilities: $20,000; Interest Expense: $5,000. What is the company's Gross Profit?

A. $60,000
B. $40,000
C. $35,000
D. $80,000

4. A company starts the year with $120,000 in Retained Earnings. During the year, it earns $40,000 in Net Income and pays out $15,000 in Dividends. What is the Ending Retained Earnings balance on the Balance Sheet?

A. $160,000
B. $175,000
C. $145,000
D. $105,000

5. A tech company has a Net Income of $100,000. This includes a non-cash Depreciation expense of $15,000. If there were no changes in working capital, what is the Operating Cash Flow?

A. $85,000
B. $100,000
C. $115,000
D. $0

6. On January 1, a business has $5,000 in Accounts Receivable. During the month, it makes $10,000 in new sales on credit and collects $7,000 in cash from previous customers. What is the ending balance of Accounts Receivable?

A. $15,000
B. $8,000
C. $3,000
D. $12,000

7. Calculate the Operating Margin for a company with $500,000 in Revenue, $200,000 in COGS, and $150,000 in Operating Expenses (selling, general, and administrative).

A. 40%
B. 30%
C. 70%
D. 60%

8. A firm spends $50,000 in cash to purchase a new delivery van. How does this transaction affect the Statement of Cash Flows?

A. Operating Cash Flow decreases by $50,000.
B. Financing Cash Flow increases by $50,000.
C. Investing Cash Flow decreases by $50,000.
D. It only affects the Balance Sheet, not the Cash Flow Statement.

9. At the beginning of the month, a company has a Cash balance of $25,000. The Statement of Cash Flows shows: Operating Activities: +$10,000; Investing Activities: –$15,000; Financing Activities: +$5,000. What is the "Ending Cash" reported on the Balance Sheet?

A. $25,000
B. $0
C. $30,000
D. $10,000

10. A business receives a $2,000 utility bill in late December but doesn't plan to pay it until January. In December, what is the impact on the Balance Sheet?

A. Accounts Payable increases by $2,000; Retained Earnings decreases by $2,000.
B. Cash decreases by $2,000; Retained Earnings decreases by $2,000.
C. Accounts Receivable increases by $2,000.
D. No impact until the cash is paid in January.

Q	Ans	Rationale
1	**B**	$750,000 (Assets) - 400,000 (Liabilities) = 350,000 (Equity$. This is the fundamental accounting equation.

2	**C**	Revenue is recorded when "earned" (the service is performed). Since the work was done in Dec 2025, all $20,000 is recognized then, regardless of when cash arrives.
3	**A**	$100,000 ({Rev) - 40,000 (COGS) = 60,000. Gross Profit only subtracts direct production costs, not rent or interest.
4	**C**	Beginning RE $120k + Net Income $40k -Dividends $15k = $145k. Net income increases equity; dividends decrease it.
5	**C**	Net Income starts the reconciliation. Since Depreciation was subtracted to get to Net Income but involves no cash, we add it back: $100k + $15k = $115k.
6	**B**	Beg AR $5k + Credit Sales $10k - Cash Collections $7k = $8k. This represents "unpaid invoices" at month-end.
7	**B**	Operating Income = Revenue $500k - COGS $200k - OPEX $150k = $150. Margin = $150k / $500k = 0.30 or 30%.
8	**C**	Purchasing long-term physical assets (CapEx) is an "Investing Activity." Because it is a cash spend, it is an outflow (decrease).
9	**A**	Start $25k +Net Change in Cash ($10k - $15k + $5k = $0) = $25k. The net movement was zero, so the balance remains the same.
10	**A**	Accounts Payable increases by $2,000; Retained Earnings decreases by $2,000. Even without cash moving, the expense is incurred. Liabilities (Accounts Payable) go up and Equity (Retained Earnings)

		goes down because the expense reduces Net Income which in turn lowers Equity via Retained Earnings.

PART THREE: SHORT-ANSWER QUESTIONS

Answer each question in 2–3 complete sentences, drawing your answers from the chapter material.

1. What is "surface-level business analysis," and why is it often misleading?

2. Explain why the author's recording studio, which appeared successful, was actually a failing business.

3. What key characteristics made the author's tutoring business a financial success compared to the recording studio?

4. According to the text, what question does Return on Assets (ROA) answer, and what does it measure?

5. Describe the personal finance trap the text highlights when people observe a friend with a luxury lifestyle.

6. Using the accounting definition provided, explain the author's personal financial position when he was living out of his car.

7. What does the text identify as "financial fragility," and how did it manifest in the author's life?

8. In rewriting his budget, why did the author focus on his largest expense categories first, such as his car?

9. After drastically cutting his expenses, what was the "catch" that revealed the ultimate constraint on the author's financial recovery?

10. What is the fundamental difference between "display" and "control" as they relate to wealth?

PART FOUR: ANSWER KEY

1. What is "surface-level business analysis," and why is it often misleading?

> Surface-level business analysis is the act of inferring a business's success from visible signals like popularity, polish, and perceived quality. It is often misleading because these signals are merely shortcuts or "optics" that do not represent the underlying economics, such as high costs, debt, or poor cash flow, which determine a business's actual financial health.

2. Explain why the author's recording studio, which appeared successful, was actually a failing business.

> Despite its professional equipment and impressive appearance, the recording studio was a failing business because of its poor economics. The "profit" it generated was actually just underpaying the owner's labor, resulting in an effective hourly wage of only $7.50 after a $60,000 personal investment. The business was an expensive, minimum-wage job with high fixed costs that was not financially sustainable.

3. What key characteristics made the author's tutoring business a financial success compared to the recording studio?

> The tutoring business was a financial success because it was a simple model that solved a recurring problem with low overhead and strong cash flow. It required minimal upfront costs, had high margins, and generated an effective hourly pay of $80 for the owner. Its capital efficiency was demonstrated by an extraordinarily high Return on Assets (ROA) of 960%.

4. According to the text, what question does Return on Assets (ROA) answer, and what does it measure?

> The text states that Return on Assets (ROA) answers the simple question: "How hard is your money actually working for you?" It is a metric that measures how effectively a business turns what it owns (its assets) into profit, exposing how efficiently its capital is being used.

5. Describe the personal finance trap the text highlights when people observe a friend with a luxury lifestyle.

> The trap is confusing visible spending with actual wealth, assuming that someone with a luxury car and big house must be financially successful. We get fooled by these visible signals and may feel jealousy, even though we intellectually understand that this lifestyle could be propped up by unsustainable debt. The text notes that we tend to penalize restraint and reward display.

6. Using the accounting definition provided, explain the author's personal financial position when he was living out of his car.

> According to the accounting definition (Assets – Liabilities = Equity), the author was in an "accumulated loss position." With assets of a $10,000 car and total liabilities of $20,000, his personal equity was negative $10,000. This meant he owed more than he owned and was, in financial terms, "underwater."

7. What does the text identify as "financial fragility," and how did it manifest in the author's life?

> Financial fragility is defined as a situation where one's life only works if nothing goes wrong. In the author's life, this manifested as a budget with zero net income, leaving no buffer for error. Any disruption, such as a missed shift, a medical bill, or even a parking ticket, would immediately push him into the red and deeper into debt.

8. In rewriting his budget, why did the author focus on his largest expense categories first, such as his car?

The author focused on the largest categories first because they determine the financial outcome, and a single decision in these areas can materially alter the math. The car alone consumed 35% of his income, making his situation mathematically unsustainable. Changing small habits would not fix a broken structure at the top of the expense list.

9. After drastically cutting his expenses, what was the "catch" that revealed the ultimate constraint on the author's financial recovery?

The catch was that his revised budget, which created a $1,000 monthly surplus, was based on unstable and unrealistic housing costs ($300 for a room or couch-surfing). The moment the budget was adjusted for real, stable housing costs, the surplus disappeared. This revealed that cutting expenses had reached its limit and his low revenue was the true constraint to achieving stability.

10. What is the fundamental difference between "display" and "control" as they relate to wealth?

Display is fragile, expensive, and must be constantly fed by income to maintain an illusion of success for outside approval. Control is quiet, endures, and compounds slowly, building resilience and optionality. Ultimately, display is about showing wealth, which consumes it, while control is about having wealth, which earns freedom.

PART FIVE: ESSAY QUESTIONS

Construct comprehensive, analytical responses using the concepts, examples, and arguments from the chapter.

1. Using the examples of the trendy restaurant versus the mom-and-pop shop, analyze the core argument that "optics lie and cash flow tells the truth." How do visible factors that suggest success often mask significant economic risks?

2. The text argues that we confuse appearance with economics in business, personal finance, and even our own lives. Discuss the psychological traps and biases detailed in the source, using the author's recording studio and the contrasting "hidden millionaire" and "VP" friends as primary examples.

3. Trace the author's process of applying a CFO-like analysis to his personal financial crisis. Explain how he used a balance sheet and income statement to understand his situation, the strategic choices he made to restructure his expenses, and what this journey revealed about the limits of austerity.

4. Deconstruct the statement: "Real wealth rarely announces itself. It shows up quietly, in optionality, peace of mind, and the ability to say no." How do the stories of Socrates, the deca-millionaire friend, and the concept of "control" support this definition of wealth over the more common definition based on "display"?

5. Compare the author's recording studio and tutoring business using the financial metrics provided in the text. Explain how a balance sheet snapshot can be misleading and why metrics like effective hourly pay and Return on Assets (ROA) are essential for revealing the true performance and value of a business.

Connecting to the Law

Law 2 states: "Displaying Wealth Consumes It." As you prepare your essay responses, consider how the pursuit of visible success—in business or personal life—can actively destroy the financial foundation that real wealth requires. The tension between display and control is not just philosophical; it shows up in every financial statement.

GLOSSARY OF KEY TERMS

Term	Definition
Accumulated Loss	An accounting term for when liabilities exceed assets, resulting in negative equity. A position where a person or business owes more than they own.
Assets	What a person or business owns and controls, such as equipment, cash, or a car.
Balance Sheet	A financial statement that provides a snapshot of assets, liabilities, and equity at a single moment in time. It shows what exists, not how well it works.
Cash Flow	The movement of money through a business or personal budget. The text positions cash flow as the indicator of truth, contrasting it with static appearances.
Effective Hourly Pay	A calculation of income divided by the hours of labor required to earn it. Used to determine the actual value of one's work after accounting for time.
Equity	The accounting definition of what is truly owned: Assets minus Liabilities.
Expenses	The cash outlays required to operate a business or manage personal finances.
Financial Fragility	A state where one's finances only work if nothing goes wrong, characterized by a lack of buffer or margin for error.
Income	What is left over after expenses are subtracted from revenue (Revenue − Expenses = Income). Referred to as "profit" in business contexts.
Income Statement	A financial statement that shows how money flows through a business or personal budget over a period, detailing revenue, expenses, and resulting income.
Liabilities	What a person or business owes, such as loans and credit card debt.
Optics	The surface-level appearance or visible signals of success (e.g., polish, popularity, expensive decor). The text argues these are unreliable indicators of economic reality.
Professional Skepticism	An instinct to look past presentation and test what is actually true, reconstructing a story from evidence and numbers rather than optics.
Return on Assets (ROA)	A metric that measures how effectively a business turns its assets into profit (Annual Profit ÷ Average Total Assets). Used to compare capital efficiency.
Revenue	The total cash coming into a business or an individual's budget before any expenses are deducted.
Surface-Level Analysis	The act of judging a business's financial strength based on visible but insufficient signals like popularity or aesthetics, rather than underlying economics.