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ANSWERS TO QUESTIONS - CHAPTER 2

1. **Accrual accounting attempts to record the effects of accounting events in the period when such events occur, regardless of when cash is received or paid. The goal is to match expenses with the revenues that they produce.**

2. **Recognition is the act of recording an event in the financial statements. When accruals are used, events are recognized before the associated cash is paid or collected.**

3. **Deferral is the recognition of revenue or expenses in a period after the cash consequences are realized, i.e., cash is collected in advance of performing the service.**

4. **If cash is collected in advance for services, the revenue is recognized when the services are rendered.**

5. **An asset source transaction increases assets and increases either liabilities or equity.**

6. **The issue of common stock, which is capital acquired from owners, increases business assets (usually cash) and equity (common stock).**

7. **The recognition of revenue on account increases the corresponding revenue account on the income statement, but does not affect the**

statement of cash flows. The cash flow statement is affected when the account is collected.

8. Asset Source Transaction   Effect on Accounting Equation

Issue of Common Stock	**Increases Assets, Increases Common Stock**
Revenue Earned	**Increases Assets, Increases Retained Earnings**
Borrowed Funds	**Increases Assets, Increases Liabilities**

9. **Revenue is recognized under accrual accounting when a revenue-producing event occurs, i.e., when the revenue is *earned*, even if no cash is collected at the time of the transaction.**

10. **The collection of cash for accounts receivable is an asset exchange transaction. Only the asset side of the accounting equation is affected because one asset account increases (cash), and another asset account decreases (accounts receivable). Total assets are unchanged.**

11. **If cash is collected in advance for services, a liability is created (unearned revenue), increasing the claims side of the accounting equation.**

12. **Unearned revenue is cash that has been collected for services that have not yet been performed.**

13. **The recognition of expenses affects the accounting equation by either decreasing assets or increasing liabilities (payables) and by decreasing stockholders' equity (retained earnings).**

14. **A claims exchange transaction is one where the claims of creditors (liabilities) increase and the claims of stockholders (retained earnings) decrease, or vice versa. The total amount of claims is unchanged.**

15. **Cash payments to creditors are <u>asset use</u> transactions. These transactions result in the reduction of an asset account (cash) and the reduction of the corresponding liability account (payables).**

16. **Expenses are recognized under accrual accounting at the time the expense is incurred or resources are consumed, regardless of when cash payment is made.**

17. **Net cash flows from operations on the cash flow statement may be different from net income because of the application of accrual accounting. Revenues and expenses reported on the income statement may be recognized before or after the actual collection or payment of cash that is reported on the cash flow statement.**

18. **The income statement reflects the change in net assets associated with operating a business, as shown by revenues and expenses. Expenses may result from a decrease in assets or an increase in liabilities. Revenues may result from an increase in assets or a decrease in liabilities.**

19. **Net income increases stockholders' claims on business assets by increasing retained earnings.**

20. **A cost can be either an asset or an expense. If the item acquired has already been used in the process of earning revenue, its cost represents an expense. If the item will be used in the future to generate revenue, its cost represents an asset.**

21. **A cost is held in the asset account until the item is used to produce revenue. When the revenue is generated, the asset is converted into an expense in order to match revenues with related expenses. Not all costs become expenses. If the value of an asset will not expire in the revenue-generating process, the asset will not become an expense. For example, the cost of land will not become an expense.**

22. **Supplies used during the accounting period are recognized in a single adjusting entry at the end of the period. The amount of supplies used is determined by subtracting the amount of supplies on hand at the end of the period from the amount of supplies that were available for use (beginning supplies balance plus supplies purchased).**

23. **An expense is a decrease in assets or an increase in liabilities that occurs in the process of generating revenue.**

24. **Revenue is an increase in assets or a decrease in liabilities that results from the operating activities of the business.**

25. **The purpose of the statement of changes in stockholders’ equity is to display the effects of business operations and stock issued to owners and dividends paid to stockholders. It identifies the ways that an entity's equity increased and decreased as a result of its operations and transactions with its stockholders.**

26. **The purpose of the balance sheet is to provide information about an entity's assets, liabilities, and stockholders’ equity and their relationships to each other at a particular point in time. It provides a list of the economic resources that the enterprise has available for its operating activities and the claims to those resources.**

27. **The balance sheet is dated as of a specific date because it shows information about an entity's assets, liabilities, and stockholders’ equity as of that date, not measured over a time period. The statement of changes in stockholders’ equity, the income statement, and the statement of cash flows reflect transactions that occur over a period of time.**

28. **Assets are listed on the balance sheet in accordance with their respective levels of liquidity (how rapidly they can be converted to cash).**

29. **The statement of cash flows explains the change in cash from one accounting period to the next. It is prepared by analyzing the cash account and summarizing where cash came from and how it was used.**

30. **An adjusting entry is an entry that updates account balances prior to preparation of the financial statements. The entry means that there is an item that needs proper measurement on the income statement and an adjustment will reflect the correct time period of earning or usage. Example: entry to recognize accrued interest revenue where the revenue has been earned but not yet collected and therefore revenue had not yet been recorded for the time period.**

31. **Temporary accounts (revenue, expense and dividends) are closed at the end of the accounting period. It is necessary to close these accounts so that revenue, expense and dividends can be accumulated from a beginning balance of zero for the next period.**

32. **Period costs are costs that are recognized in an accounting period. Examples of period costs include rent expense, utilities expense, and salaries expense.**

33. **Salary of the tax return preparer could be directly matched with the revenue that it produces.**

34. **The four stages of the accounting cycle: Record transactions; adjust the accounts; prepare statements; and close the temporary accounts. The adjustment and closing processes have been added to the cycle in this chapter. It is necessary to adjust accounts so that the accounts will reflect the correct balances under the accrual basis of accounting. The closing process (transferring the balances of the temporary accounts to retained earnings) is necessary so that the temporary accounts have a zero balance at the beginning of the next accounting cycle.**

35. **The three elements of the fraud triangle are (1) the availability of an opportunity (2) the existence of some form of pressure leading to an incentive and (3) the capacity to rationalize.**

36. **An executive who falsely certifies the company's financial reports is subject to a fine up to $5 million and imprisonment up to 20 years.**