

1. Income is an increase in the net assets of an entity from its operations over a period of time. There are three important pieces to this definition:

- Income is an increase in net assets.
- Income is the result of an entity's operations.
- Income is measured over a period of time.

2. Net assets is the difference between total assets and total liabilities. Net assets is another name for equities.

3. Revenues are increases in assets or decreases in liabilities resulting from operations. Examples include sales revenues, interest revenue, and licensing revenue.

4. Expenses are the assets used or liabilities incurred (or equities issued, see the answer to Question 6) in the process of carrying out operations. Examples include cost of goods sold, depreciation expense, interest expense, rent expense and marketing expense.

5. No. Expenses are not necessarily cash outflows in the period in which they are recorded. Expenses are resources used or liabilities incurred, and it is not necessary that those assets were purchased or liabilities were discharged in the same period in which the expense is recognized. Expenses are not the same as expenditures of cash.

(Another possibility is that expenses are recorded in conjunction with the issuance of equity, in which cash no cash outflow is required.)

6. No. Expenses are almost always associated with an outflow of cash that occurs at some time. For example, depreciation expense may be recorded for an asset that was bought with cash many years ago. Wage expense may be recorded for wages that will be paid in a future period.

Sometimes, however, an expense is related to an item that is not cash. For example, if a company exchanges common stock for legal services, cash is not used. Of course, there is an implicit cash component, as the stock could have been sold for cash instead of exchanged for services.

For more detail, note that expenses can be recorded in conjunction with:

expirations of assets, e.g.,

Depreciation and Amortization Expense	xxx	
Patents		xxx

incurrence of liabilities, e.g.,

Wages expense	xxx	
Wages payable		xxx

or issuances of equity, e.g., (giving a dotcom company shares of common stock

in exchange for its putting advertisements on its Web site):

Advertising expense	xxx	
Common stock		xxx

7. No. Revenues are not necessarily associated with inflows of cash in the same period in which they are recognized. Revenues are assets generated or liabilities discharged, and those assets could be other than cash, e.g., a receivable could be generated.

8. No. Revenues are almost always associated with inflows of cash that occur at some time. For example, if a customer pre-pays for a magazine subscription, the cash inflow occurs before the revenue is recognized. A liability, Unearned revenue, is created upon receipt of the cash.

Revenues could also be received in a form other than cash. A customer could give shares of its stock in exchange for goods or services that the firm later sells (hopefully) for cash.

9. No, no, a thousand times NO. Dividends are not the result of an entity's operations. They are a financial transaction between the entity and its owners; i.e., the declaration and payment of dividends are capital transactions.

10. Yes, yes, a thousand times YES. Interest is part of the cost of raising financing from sources other than owners. It is considered as a normal part of an entity's operations, and is not a capital transaction with the entities owners. Therefore, interest is an expense.

11. The earnings process must be substantially complete, an exchange must have taken place, and collection must be reasonably certain.

12. At the point of sale (McDonald's), when goods are shipped (Lands' End), or when goods are accepted by the customer (local automobile dealer).

13. Accrual accounting is any method of accounting that separates the measurement of revenues and expenses from the receipt and expenditure of cash.

14. Matching is the process of making sure all the costs incurred in generating the revenues recognized in a period are taken as expenses in that period.

15. They are debits. This stems from the convention that increases in assets are debits. If an expense is an expiration of an asset, the asset must be credited. To preserve debits equal credits, the expense must be debited. Therefore, an increase in an expense is a debit.

16. They are credits. This stems from the convention that increases in assets are debits. If a revenue generates an asset, the asset must be debited. To preserve debits equal credits, the revenue must be credited. Therefore, an increase in a revenue is a credit.

17. A temporary account is any account that will be closed at the end of the accounting period. Their purpose is to facilitate the preparation of the income statement.

18. Adjustments are amounts required to update the accounts in the absence of a specific transaction.

19. The process of adjustment is crucial to accrual accounting. If we are going to separate the recording of expenses and revenues from the receipt and disbursement of cash, some entries must be made that do not occur in conjunction with a specific transaction. For example, accrual accounting requires that depreciation expense must sometimes be recorded at times other than when the asset is bought or sold.

20. Closing is the act of bringing the balance in an account to zero.

21. Yes. In fact, accounts that are not closed must be shown somewhere on the balance sheet. That's what the balance sheet does: it shows the balances (sometimes highly aggregated) in all accounts with non-zero balances.

22. No, accounts that are closed do not appear on the balance sheet. Their balances are zero by definition, after closing. Their pre-closing balances are part of Retained earnings, because that is the account to which the temporary accounts are closed.

23. Cash-basis accounting would recognize revenues when cash is received. It would recognize expenses when cash is disbursed.

24. One strength of cash-basis accounting is that it is easy. Only one asset account is required, and no adjustments need be made. The only entries that are made are made in conjunction with the receipt and expenditure of cash. Cash-basis accounting is no more difficult than keeping a check book.

Cash-basis accounting has many weaknesses. It does not do a good job of tracking resources produced and consumed because all it does is track cash. It also doesn't result in a very informative balance sheet: the only asset recognized is cash.

25. It is objective in the sense that any two observers should get the same results when they add up the cash in and cash out.

26. But management can manipulate cash basis income. All that has to be done is to speed up or slow down cash receipts and expenditures. For example, a firm that wishes to raise income in the next period could pay all its outstanding bills before the period begins. The basic reason that cash-basis income can be easily manipulated is that it does not track resources and obligations created and used, it only tracks cash.