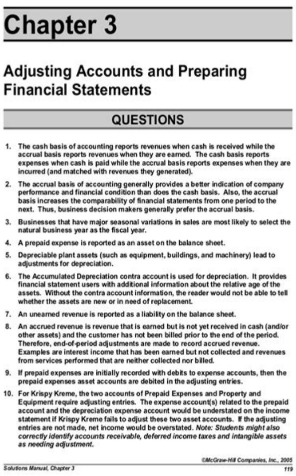

Chapter 3

Adjusting Accounts and Preparing Financial Statements

QUESTIONS

1. The cash basis of accounting reports revenues when cash is received while the accrual basis reports revenues when they are earned. The cash basis reports expenses when cash is paid while the accrual basis reports expenses when they are incurred (and matched with revenues they generated).
2. The accrual basis of accounting generally provides a better indication of company performance and financial condition than does the cash basis. Also, the accrual basis increases the comparability of financial statements from one period to the next. Thus, business decision makers generally prefer the accrual basis.
3. Businesses that have major seasonal variations in sales are most likely to select the natural business year as the fiscal year.
4. A prepaid expense is reported as an asset on the balance sheet.
5. Depreciable plant assets (such as equipment, buildings, and machinery) lead to adjustments for depreciation.
6. The Accumulated Depreciation contra account is used for depreciation. It provides financial statement users with additional information about the relative age of the assets. Without the contra account information, the reader would not be able to tell whether the assets are new or in need of replacement.
7. An unearned revenue is reported as a liability on the balance sheet.
8. An accrued revenue is revenue that is earned but is not yet received in cash (and/or other assets) and the customer has not been billed prior to the end of the period. Therefore, end-of-period adjustments are made to record accrued revenue. Examples are interest income that has been earned but not collected and revenues from services performed that are neither collected nor billed.
9. If prepaid expenses are initially recorded with debits to expense accounts, then the prepaid expenses asset accounts are debited in the adjusting entries.
10. For Krispy Kreme, the two accounts of Prepaid Expenses and Property and Equipment require adjusting entries. The expense account(s) related to the prepaid account and the depreciation expense account would be understated on the income statement if Krispy Kreme fails to adjust these two asset accounts. If the adjusting entries are not made, net income would be overstated. *Note: Students might also correctly identify accounts receivable, deferred income taxes and intangible assets as needing adjustment.*