Chapter 04
Adjustments, Financial Statements, and the Quality of Earnings

ANSWERS TO QUESTIONS

1. A trial balance is a list of the individual accounts, usually in financial statement order, with their debit or credit balances. It is used to provide a check on the equality of the debits and credits.

2. Adjusting entries are made at the end of the accounting period to record all revenues and expenses that have not been recorded but belong in the current period. They update the balance sheet and income statement accounts at the end of the accounting period.

3. The four different types are adjustments for:
   (1) Deferred revenues -- previously recorded liabilities that need to be adjusted at the end of the period to reflect revenues that have been earned (e.g., Unearned Ticket Revenue must be adjusted for the portion of ticket revenues earned in the current period).
   (2) Accrued revenues -- revenues that have been earned by the end of the accounting period but which will be collected in a future accounting period (e.g., recording Interest Receivable for interest revenues not yet collected).
   (3) Deferred expenses -- previously recorded assets that need to be adjusted at the end of the period to reflect incurred expenses (e.g., Prepaid Insurance must be adjusted for the portion of insurance expense incurred in the current period).
   (4) Accrued expenses -- expenses that have been incurred by the end of the accounting period but which will be paid in a future accounting period (e.g., recording Utilities Payable for utilities expense incurred during the period that has not yet been paid).

4. A contra-asset is an account related to an asset that is an offset or reduction to the asset's balance. Accumulated Depreciation is a contra-account to the equipment and buildings accounts.
5. The net income on the income statement is included in determining ending retained earnings on the statement of stockholders’ equity and the balance sheet. The change in the cash account on the balance sheet is analyzed and categorized on the statement of cash flows into cash from operating activities, investing activities, and financing activities.

6. (a) Income statement: Revenues (and gains) - Expenses (and losses) = Net Income  
(b) Balance sheet: Assets = Liabilities + Stockholders’ Equity  
(c) Statement of cash flows: Changes in cash for the period = Cash from Operations + Cash from Investing Activities + Cash from Financing Activities  
(d) Statement of stockholders’ equity: Ending Stockholders’ Equity = (Beginning Contributed Capital + Stock Issuances - Stock Repurchases) + (Beginning Retained Earnings + Net Income - Dividends Declared)

7. Adjusting entries have no effect on cash. For deferred revenues and deferred expenses, cash was received or paid at some point in the past. For accruals, cash will be received or paid in a future accounting period. At the time of the adjusting entry, there is no cash being received or paid.

8. Earnings per share = Net income / average number of shares of stock outstanding during the period.  
Earnings per share measures the average amount of net income for the year attributable to one share of common stock.

9. Net profit margin = Net income / net sales  
The net profit margin measures how much of every sales dollar generated during the period is profit.

10. An unadjusted trial balance is prepared after all current transactions have been journalized and posted to the ledger. It does not include the effects of the adjusting entries. The basic purpose of an unadjusted trial balance is to check the equalities of the accounting model (particularly, Debits = Credits) and to provide the data in a form convenient for further processing in the accounting information processing cycle.

In contrast, an adjusted trial balance is prepared after the effects of all of the adjusting entries have been applied to the corresponding (prior) unadjusted trial balance amounts. The basic purpose of an adjusted trial balance is to insure that accuracy has been attained in applying the effect of the adjusting entries. The adjusted trial balance provides a second check in the model equalities (primarily Debits = Credits). It also provides data in a form convenient for further processing.
11. The closing entry is made at the end of the accounting period to (1) transfer the balances in the temporary income statement accounts to retained earnings and (2) reduce the revenue, gain, expense, and loss accounts to a zero balance so that they can be used for the accumulation process during the next period. A closing entry must be entered into the system through the journal and posted to the ledger accounts to state properly the temporary and permanent account balances (i.e., zero balances in the temporary accounts).

12. (a) Permanent accounts -- balance sheet accounts; that is, the asset, liability, and stockholders' equity accounts (these are not closed at the end of each period).
(b) Temporary accounts -- income statement accounts; that is, revenues, gains, expenses, and losses (these are closed at the end of each period).
(c) Real accounts -- another name for permanent accounts.
(d) Nominal accounts -- another name for temporary accounts.

13. The income statement accounts are closed at the end of the accounting period because, in effect, they are temporary subaccounts to retained earnings (i.e., a part of stockholders' equity). They are used only for accumulation during the accounting period. When the period ends, these accumulated accounts must be transferred (closed) to retained earnings. The closing process serves:

(1) to correctly state retained earnings, and
(2) to clear out the balances of the temporary accounts for the year just ended so that these subaccounts can be used again during the next period for accumulation and classification purposes.

Balance sheet accounts are not closed at the end of the period because they reflect permanent accumulated balances of assets, liabilities, and stockholders' equity. Permanent accounts show the entity's financial position at the end of the period and are the beginning amounts for the next period.

14. A post-closing trial balance is a listing taken from the ledger after the adjusting and closing entries have been journalized and posted. It is not a necessary part of the accounting information processing cycle but it is useful because it demonstrates the equality of the debits and credits in the ledger after the closing entry has been journalized and posted and that all temporary accounts have zero balances.
ANSWERS TO MULTIPLE CHOICE

1. c
2. b
3. b
4. a
5. b
6. c
7. c
8. d
9. c
10. a