Chapter 4 Study Guide: Adjustments, Financial Statements, and Financial Results

1. Introduction to Adjustments

- **Adjustments** are necessary in accounting to ensure that the financial statements accurately reflect the company's financial position at the end of an accounting period. These adjustments are made under **accrual accounting** to match revenues with the expenses incurred to generate them, in accordance with the **matching principle**.
- Adjustments typically occur in two key areas:
    1. **Deferrals**: Cash is exchanged before the revenue or expense is recognized.
    2. **Accruals**: Revenue or expenses are recognized before the cash is exchanged.

2. Types of Adjustments

- **1. Deferrals**:
    - **Prepaid Expenses** (Asset adjustments): Payments made in advance for goods or services to be received in future periods (e.g., prepaid insurance).
    - **Unearned Revenues** (Liability adjustments): Cash received in advance for goods or services to be delivered in the future (e.g., advance customer payments).
- **2. Accruals**:
    - **Accrued Revenues**: Revenue that has been earned but not yet received in cash or recorded (e.g., services rendered but not yet billed).
    - **Accrued Expenses**: Expenses that have been incurred but not yet paid or recorded (e.g., wages or utilities expenses incurred but not yet paid).

3. The Adjusting Process

- Adjustments are made at the **end of the accounting period** before preparing the financial statements.
- The process ensures that the company's **income statement** reflects revenues and expenses for the correct period and the **balance sheet** accurately reflects the financial position.

4. Preparing Adjusted Financial Statements

5. Closing Entries

- **Closing entries** are journal entries made at the end of an accounting period to transfer the balances of temporary accounts (revenues, expenses, and dividends) to permanent accounts (retained earnings).

  The steps in the closing process include:

  1. **Close revenue accounts** to the Income Summary account.
  2. **Close expense accounts** to the Income Summary account.
  3. **Close the Income Summary account** to Retained Earnings.
  4. **Close the dividends account** to Retained Earnings.

6. Financial Results and Performance Evaluation

- After adjusting the accounts and preparing the financial statements, the company can evaluate its financial performance:
  - **Profitability**: Net income after adjusting for revenues and expenses.
  - **Liquidity**: Cash flow from operating activities, which can be affected by adjustments such as accrued expenses or revenues.
  - **Solvency**: The company's ability to meet long-term obligations, which may be impacted by changes in liabilities.

7. Key Terms to Know

- **Deferrals**
- **Accruals**
- **Prepaid Expenses**
- **Unearned Revenues**
- **Accrued Revenues**
- **Accrued Expenses**
- **Adjusted Trial Balance**
- **Closing Entries**
- **Permanent Accounts**
- **Temporary Accounts**
- **Income Summary**
- **Retained Earnings**

Practice Questions for Chapter 4: Adjustments, Financial Statements, and Financial Results

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1. Classifying Adjustments

Problem 1.1: Classifying Adjustments

For each of the following, classify the type of adjustment as a **Deferral** (Prepaid Expenses or Unearned Revenues) or **Accrual** (Accrued Revenues or Accrued Expenses):

- Prepaid rent for office space for the next 12 months
- Salaries earned by employees, but not yet paid
- Revenue earned from services performed, but not yet billed to customers
- Advance payment from a customer for services to be performed next quarter
- Insurance premium paid in advance for the upcoming year

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2. Preparing Adjusting Journal Entries

Problem 2.1: Preparing Adjusting Journal Entries

At the end of the accounting period, the following situations need adjustments:

1. **Prepaid Insurance**: The company paid $12,000 for an insurance policy on January 1 that covers the year. As of December 31, $10,000 of the insurance has been used.
2. **Unearned Revenue**: A company received $5,000 in advance for services to be performed next year. As of the end of this period, $2,000 worth of services have been completed.
3. **Accrued Salaries**: The company owes $3,000 in salaries that will be paid next month.
4. **Accrued Interest Revenue**: The company earned $500 in interest on a loan, which has not yet been recorded.

For each situation, prepare the necessary adjusting journal entry.

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3. Adjusted Trial Balance Calculation

Problem 3.1: Preparing an Adjusted Trial Balance

The following information is available for XYZ Corp. on December 31:

- Cash: $10,000
- Accounts Receivable: $5,000
- Prepaid Rent: $2,000 (for the next 4 months)
- Accounts Payable: $3,000
- Unearned Revenue: $1,500
- Revenue: $50,000
- Salaries Expense: $12,000
- Insurance Expense: $3,000
- Accumulated Depreciation: $4,000
- Common Stock: $20,000
- Retained Earnings: $8,000

Given the adjustments, prepare an adjusted trial balance. Assume:

- Prepaid rent has been fully utilized for the period.
- $500 of the unearned revenue has been earned.
- Accrued salaries of $2,000 are due at the end of the period.

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4. Preparing Financial Statements After Adjustments

Problem 4.1: Preparing Financial Statements

Using the adjusted trial balance from Problem 3.1, prepare the following financial statements:

1. **Income Statement**
2. **Balance Sheet**

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5. Closing Entries

Problem 5.1: Closing Entries

At the end of the period, XYZ Corp. has the following balances:

- Revenue: $40,000
- Expenses (Total): $30,000
- Dividends: $5,000

Prepare the closing entries for XYZ Corp.

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6. Evaluating Financial Results

Answers to Practice Questions

Problem 1.1: Classifying Adjustments

- Prepaid rent for office space for the next 12 months → **Deferral (Prepaid Expense)**
- Salaries earned by employees, but not yet paid → **Accrual (Accrued Expense)**
- Revenue earned from services performed, but not yet billed to customers → **Accrual (Accrued Revenue)**
- Advance payment from a customer for services to be performed next quarter → **Deferral (Unearned Revenue)**
- Insurance premium paid in advance for the upcoming year → **Deferral (Prepaid Expense)**

Problem 2.1: Preparing Adjusting Journal Entries

1. **Prepaid Insurance**

- Debit: Insurance Expense $10,000
- Credit: Prepaid Insurance $10,000

2. **Unearned Revenue**

- Debit: Unearned Revenue $2,000
- Credit: Revenue $2,000

3. **Accrued Salaries**

- Debit: Salaries Expense $3,000
- Credit: Salaries Payable $3,000

4. **Accrued Interest Revenue**

- Debit: Interest Receivable $500
- Credit: Interest Revenue $500

Problem 3.1: Adjusted Trial Balance Calculation

Adjusted balances:

- Prepaid Rent: $500 (Remaining balance after use)

- Unearned Revenue: $500 (Balance after earning)
- Salaries Payable: $2,000 (Accrued salaries adjustment)

Adjusted Trial Balance

- Cash: $10,000
- Accounts Receivable: $5,000
- Prepaid Rent: $500
- Accounts Payable: $3,000
- Salaries Payable: $2,000
- Unearned Revenue: $500
- Revenue: $50,000
- Salaries Expense: $14,000
- Insurance Expense: $3,000
- Accumulated Depreciation: $4,000
- Common Stock: $20,000
- Retained Earnings: $8,000

Problem 4.1: Preparing Financial Statements

- **Income Statement**
  - Revenues: $50,000
  - Expenses: $17,000 (Salaries Expense + Insurance Expense)
  - **Net Income**: $33,000
- **Balance Sheet**
  - Assets:
    - Cash: $10,000
    - Accounts Receivable: $5,000
    - Prepaid Rent: $500
    - Accumulated Depreciation: $4,000
    - Total Assets: $19,500
  - Liabilities:
    - Accounts Payable: $3,000
    - Salaries Payable: $2,000
    - Unearned Revenue: $500
    - Total Liabilities: $5,500
  - Equity:
    - Common Stock: $20,000
    - Retained Earnings: $8,000 + $33,000 = $41,000
    - Total Equity: $61,000
  - Total Liabilities + Equity: $61,000

Problem 5.1: Closing Entries

1. Close Revenue to Income Summary:

- Debit: Revenue $40,000
- Credit: Income Summary $40,000

2. Close Expenses to Income Summary:

- Debit: Income Summary $30,000
- Credit: Expenses $30,000

3. Close Income Summary to Retained Earnings:

- Debit: Income Summary $10,000
- Credit: Retained Earnings $10,000

4. Close Dividends to Retained Earnings:

- Debit: Retained Earnings $5,000
- Credit: Dividends $5,000

Problem 6.1: Evaluating Profitability

- **Gross Profit** = $200,000 - $120,000 = $80,000
- **Operating Income** = $80,000 - $40,000 = $40,000
- **Net Income** = $40,000 - $10,000 = $30,000