CHAPTER 4 LECTURE NOTES

Volume 4, Issue 1 October 2000

CHAPTER 4 IS NOT A HALLOWEEN DIRTY TRICK!

ADJUSTING ENTRIES ARE LIKE ADJUSTING THE PICTURE ON A TELEVISION OR WIPEING THE MIRRORS OFF AFTER SHOWERING—you can see a clearer picture of the results of operations for a period of time (IS), the activities in the capital account for a period of time (St. of OE), and the condition of the business at a point in time (BS).

The trick to this chapter is not to make anything more out of it than it is--It is just:

1. CHANGING THE BALANCES OF CERTAIN ACCOUNTS THAT AT THE END OF THE FISCAL PERIOD ARE NOT ACCURATE (possibly supplies and wages, for sure insurance and depreciation)

2. USING A BIG PIECE OF COLUMNAR PAPER (CALLED A WORK SHEET) TO GATHER ALL THE INFORMATION YOU NEED TO DO THE FINANCIAL STATEMENTS. Like gathering all the ingredients you need for a recipe or the tools and parts you might need to repair something before beginning.

3. TAKING EVERYTHING YOU HAVE LEARNED SO FAR AND MAKING IT HAPPEN (for example, after the work sheet is completed, you prepare the financial statements from it, you journalize and post the adjusting entries from the work sheet to bring your general ledger up to date). NOTHING NEW OR MYSTERIOUS. You have the information and tools.

Why is she making such a big deal--she's scaring me!

So, if that is true, why am I making such a big deal out of trying to keep everyone calm? Because, students have in the past let this chapter loom as something mysterious when it is truly a procedural action and device to make the clearest picture of the business possible.

SO, LET'S GET ON WITH IT!

First, recall the Accounting Steps—p. 108 text and the Accounting Cycle chapters on p. 109. We are now at the summarizing step—the financial statements. Before they can be prepared, we must gather all the ingredients or parts in one place—THE WORK SHEET.

Second, on p. 110, you will see a picture of the column headings—read left to right. On p. 110 and 111, each column is described and the different classifications are listed. Arrows lead each classification to its destinations in the work sheet. If this is confusing to your eyes at this point, at least read the descriptions. You can always come back to these illustrations later if you need to.

Third—ADJUSTMENTS ALWAYS APPEAR FIRST IN THE WORK SHEET (in a manual system). Having said that, on pages 112-116 illustrate with T accounts how the ledger will look in the end so that you will understand what is going on in the work sheet and eventual journal entries.
SUPPLIES ADJUSTMENT

Remember when you bought supplies in chapters 1-3? Where did we put the debit to an entry? Supplies? Supplies Expense? We put it in asset Supplies, because we have not used it yet. Each time we use Supplies, we have incurred an expense, a Supplies Expense. But, it is too time consuming to run to your books (or your computer) and reduce (credit) Supplies by the amount of that ream of paper and increase (debit) Supplies Expense by the amount of that ream of paper. Instead, we wait until the end of a fiscal or accounting period (in this case a month) to make an ADJUSTING ENTRY.

To determine the amount of the adjusting entry (p. 112), somebody needs to count what is left. We already know what we bought--that amount is in Supplies. To determine what has been used (or stolen), subtract what we have left from what we bought. EACH ADJUSTMENT IS DIFFERENT IN DETERMINING THE INCREASE TO AN EXPENSE AND DECREASE TO AN ASSET. Don’t fall into the trap of believing that because you do the Supplies adjustment this way, that this is how you do all the others.

Please reread the above statement.

INSURANCE ADJUSTMENT

Remember when you bought insurance in chapters 1-3? Where did we put the debit to an entry? Prepaid Insurance? Insurance Expense? We put it in asset Prepaid Insurance, because we have not used it yet. Each day we use the asset Prepaid Insurance, we have incurred an expense, an Insurance Expense. But, it is too time consuming to run to your books (or your computer) each day and reduce (credit) Prepaid Insurance by the amount of that day's protection and increase (debit).

(Insurance Adjustment continued)

Insurance Expense by the amount of that day's protection. Instead, we wait until the end of a fiscal or accounting period (in this case a month) to make an ADJUSTING ENTRY.

To determine the amount of the adjusting entry (p. 113), somebody needs to count how many days of protection we have used and multiply times the amount per day. We already know the used amount (most of the time it is given in the text). WE ARE ALWAYS LOOKING FOR A USED AMOUNT (EXPENSE) AND THAT SAME AMOUNT REDUCES A CORRESPONDING ASSET--makes the picture clearer. DID YOU NOTICE THAT WE DIDN'T COMPUTE THIS ADJUSTMENT AS WE DID THE SUPPLIES? Good, you calculate what you have to in order to find that used or expense amount, and the amount by which you will reduce the asset.

DEPRECIATION ADJUSTMENT

Now, this is still another adjustment that is slightly different from the other two--BUT WITH THE SAME PURPOSE--to make a clearer picture of the results of operations and the condition of the business.

Some stuff about depreciation:

Depreciation is at best an estimate--allowed by the IRS to write off the loss of usefulness of an asset (whether it really has lost any usefulness or not--it is on paper--and a wonderful write-off)

Depreciation is of two types:

1. Wear and tear
Have you ever had a car and somebody smacked it in the parking lot and left a ding? Or the paint job fades after a time?
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2. Obsolescence

Have you bought a computer and two years later, you needed something bigger, better, faster? The old computer still worked, but it wasn't enough for your needs. This happens to businesses also. Things become obsolete.

Again, we could run to the books each day and adjust for the amount of loss of usefulness that day, but it is too time consuming. So at the end of the fiscal or accounting period, someone computes the amount of the depreciation using one of several methods prescribed.

The only method mentioned here is straight-line depreciation (Cost-salvage value divided by the number of years of estimated useful life). This results in an annual amount of depreciation for the asset. If you need a monthly amount, divide by 12. See p. 113-114.

Now, here's the catch on this adjustment—Remember, each adjustment is differently calculated, but always the same in trying to find an expense amount to debit and an asset to credit.

Thus: We will debit Depreciation Expense, name of asset (just like the other adjustments) and credit an asset—this asset is called Accumulated Depreciation, name of asset. Why don't we just credit the asset (say Equipment instead of Accumulated Depreciation, Equipment)? What would happen to asset Equipment if you credited it each month for the depreciation? What would the balance eventually become?

And how would that look on your balance sheet when you go to the bank for a loan or try to sell your business with no Equipment? But, you say, I still have the Equipment. Right! Always keep the cost amount of the asset (say Equipment) on your books and in your balance sheet (see p. 114 bottom). That is why we credit another asset account called Accumulated Depreciation, name of asset—a contra account (like Drawing is a contra account). Contra means the signs are contrary to or contra to the account it accompanies. If we do that, we always have a record of how much has accumulated or built up in depreciation on that asset and we also have kept the original cost of the asset in the main asset account. Look at the T accounts in the middle of p. 114 and 115. See the brackets?

Next to computing the Supplies adjustment correctly, this entry is the most misunderstood.

WAGES EXPENSE (the last one for a while)

First, study the three timelines/calendars on p. 115 and 116. This adjustment may or may not happen. It depends on how the pay periods and fiscal period coincide (or don't coincide). Some businesses and municipalities have made their pay periods match their fiscal period just to avoid this adjustment. And we don't even deal in this chapter with all the adjustments of employment taxes (see there's lots to be thankful for).

On either of the timelines, you will see that the end of a fiscal or accounting period has occurred during the middle of a pay period. But the employees don't get paid until the next pay period. But with accrual basis accounting, we make an adjustment for the amount they have earned (Wages Expense) and we owe (Wages Payable) from the last payday to the end of the fiscal period. You might want to read that again.

Study the T accounts at the bottom of p. 116. What would happen if we didn't make this adjustment? Would we understate or overstate Wages Expense? Would we understate or overstate Wages Payable (a liability)? If we understate an expense, what does it do to our net income? If we understate a liability, what does it do to our balance sheet? Do we have a clear
picture if we don't adjust for wages that employees have earned, but we don't pay until the next payday (which is in the new fiscal period)?

**NOW FOR THE FUN PART--The Work Sheet**

Now that your brain is wrung out on concepts, let's do some procedural stuff. We will be working from left to right--one step at a time.

After text p. 120, you will find some film with print on it. Lift the top two films and look at Figure 3. The trial balance--in your homework, you prepare a trial balance from YOUR GENERAL LEDGER ACCOUNTS. Make sure it balances before proceeding.

Now, drop Figure 4 film over Figure 3. You will see the adjustments that we just did (at great length) in the chapter. Notice they are lettered pairs for quick reference. BIG THING! Since this trial balance only contains those accounts with balances greater than zero, that means that some accounts needed to do the adjusting entries on the work sheet are not there. Just write them in the Account Name column below the totals of the Trial Balance. Some students (and computer programs) prefer that all accounts be listed in order. You can too, in anticipation of adjustment. But---it requires more writing. It is a trade-off--more writing, maybe less confusion.

Also notice the Steps and descriptions at the bottom. These pages will be your model--just different numbers.

Now, drop Figure 5 film over Figure 4 film. You will see that an ADJUSTED TRIAL BALANCE has been prepared. Each account in the trial balance plus or minus any adjustment is extended to the trial balance. Lots of muttering should go on here--As in "Prepaid Insurance $360 debit minus $30 credit equals a $330 debit, and it goes in the Adjusted Trial Balance debit column."

Try muttering through Supplies. Then try Wages Expense. The Adjusted Trial Balance must balance before proceeding.

**NOW THE GRAND FINALLY--ALMOST!**

Drop Figure 6 film over Figure 5 film. You will see that from the ADJUSTED TRIAL BALANCE (don't look back at any other numbers), each account is extended to its appropriate statement columns. Again, mutter, because you don't want a debit balance to magically turn into a credit balance. If you have trouble remembering what statements things go in, see your working papers for the charts. Materials map checklist…

**OKAY, NOW THE GRAND FINALE!**

After every account has been extended to their statements, total all four columns. Do the income statement columns balance? No? Good. They shouldn't. Why not? Right, you hope you earned more revenue than you incurred expenses. Take the difference and add it to the smaller side and total both columns and double rule.

After totaling the balance sheet columns, do they balance? No? Good. They shouldn't. The difference represents the net income and it MUST BE THE SAME AS THE DIFFERENCE YOU FOUND IN THE INCOME STATEMENT COLUMNS, or something is wrong. Page 122 may also help as an illustration.

Again, add the difference between the two columns of the balance sheet columns to the smaller side and total and double rule.

**THE FINANCIAL STATEMENTS**

See p. 125 for the statements done in the order shown from the numbers on the work sheet columns. Track the numbers so you can do it yourself on your homework.

JOURNALIZE (AND POST if there are working papers for it) THE ADJUSTING ENTRIES from the work sheet. See p. 126. SEE, I TOLD YOU IT WASN'T HARD.