ACCT 100
Chapter 5 - Adjusting Entries and the Worksheet
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Where We've Been

We've been working our way through a complete accounting cycle. Specifically, we have learned to:

- Analyze business transactions
- Journalize the transactions in a journal
- Post the transactions to a ledger
- Prepare a trial balance

Where We're Going

We will continue the accounting cycle in the next few chapters as follows:

- Gather adjustments and prepare a worksheet - This chapter
- Prepare financial statements - This chapter (& previous ones)
- Journalize and post adjustments - This chapter
- Journalize and post closing entries - Chapter 6
- Prepare a post closing trial balance - Chapter 6

You are well on your way to completing a full accounting cycle!

Adjustments

Adjustments are needed because certain accounts in the trial balance do not contain accurate balances. That is, certain accounts are not up-to-date. Adjustments are internal transactions that need to be recorded to bring the ledger accounts up to date. They are called internal transactions because there are no outside source documents which tell the accountant that an economic transaction has taken place. All adjustments in this chapter will record the usage or expiration of a cost. All adjustments in this chapter will include a debit to an expense account and a credit to a balance sheet account. This means that all these adjustments will have a direct impact on all of the financial statements. For this reason, they are very important to understand. This chapter introduces three basic adjustments that almost all firms must make. We will discuss these adjustments in detail in class.

The supplies adjustment

This adjustment is necessary because so far, all we have done is debit the asset account called supplies whenever we have purchased supplies. Without adjustment, this account would keep getting bigger and bigger. As you recall, an asset is something of value. The problem is, after the supplies are used up, they are no longer an asset. They become a cost of doing business which was our definition of an expense. The adjustment will decrease the asset account and increase the expense accounts.

You need to determine the amount in the supplies account. You then need to compare this amount to the actual supplies on hand. Most of the time, the adjustment amount will be for the difference. But, be careful. In all cases, you need to adjust for the amount of supplies used. Sometimes, the amount used will be given to you in the problems - sometimes you will have to calculate it. In all cases the adjustment is:

Dr. Supplies Expense

Cr. Supplies

The effect of not making this adjustment is that net income will be overstated and so will assets.

The Adjustment to Prepaids

As you will recall, we have learned to debit a prepaid when we pay for something more than one month in advance. The problem occurs because as time passes, the company no longer has an asset of value. Instead they have an expired cost. The adjustment removes the worthless asset from the balance sheet and places an expense on the books. The journal entry is:

Dr. Insurance Expense (or advertising expense or rent expense depending on the item prepaid)

Cr. Prepaid Insurance (or advertising or rent)

The effect of not making the entry is that net income is overstated and so are assets. For professional service businesses, like doctors, lawyers, accountants, appraisers, etc. insurance costs are exorbitant and failure to make this adjustment could mean a very large misstatement on the financial statements.

Depreciation of Equipment

Fixed or Plant Assets are assets that last longer than one year. Popular kinds of fixed assets are property, plant and equipment. (You will have several chapters on this topic in ACCT 101 next semester.) Eventually these assets wear out and are used up. However, if no adjustment is made, the asset will continue to be carried on the books at its original cost. The accountant's answer to this dilemma is depreciation. Depreciation is the systematic allocation of the asset's cost over its useful life. We will only learn one method of depreciation, although there are many to choose from. The one we will learn is called straight-line deprecation. We will calculate it as follows:

(Cost - Estimated Salvage Value) / Life

= Annual Depreciation (Life can be stated in terms of years or months, depending on how often depreciation is computed and recorded.)

Most companies record this on a monthly basis, so the "Life" is usually expressed in terms of the number of months in the asset's life. If you held the asset for the entire year, and you were computing monthly depreciation, you would simply multiply the monthly depreciation by 12 months to obtain the depreciation for the year. If the company bought the asset during the year, you would need to pro-rate the depreciation expense and only record the depreciation for the portion of the year that the company owned the asset. For example, if an asset was purchased on

3/1 and the company has a 12-31-XX year end, then you would only record depreciation for 10 months or 10/12 of a year.

The journal entry is:

Dr. Depreciation Expense

Cr. Accumulated Depreciation

The Accum. Depn account is a contra asset account. This means that it works contrary to a normal asset balance. The plus and minus signs are the reverse of a normal asset. As the name implies, this account keeps track of the accumulated depreciation of the asset. It grows every year. On the balance sheet, assets are presented at their net book value, which means that you show the asset's cost less its accumulated depreciation. The difference is termed the book value.

The effect of not recording this asset is that net income is overstated and assets are overstated.

The Worksheet - A helpful tool for adjustments

The worksheet is an internal document. It stays within the accounting department. It is not a formal financial statement. It is used to help gather the data so that the appropriate adjustments can be made.

The first few columns of the worksheet are for the normal trial balance that we learned in the last chapter. The four adjustments that were just discussed are dropped into the appropriate debit or credit adjustment column. The next set of columns are called the adjusted trial balance columns. This is just a horizontal math exercise. Take the trial balance columns and extend the adjustments across. The debits must still equal the credits when you are done footing the columns. From that point on, all one must do is drop the amounts into the appropriate income statement or balance sheet columns. The only accounts that go on the income statement columns are revenues and expenses. All the rest go in the balance sheet columns. The balancing figure that must match on both sets of columns is the resulting net income or loss.

Completing the financial statements

You have already learned how to do a complete set of financial statements consisting of an income statement, a statement of owner's equity and a balance sheet. Nothing new here. The only difference is now you will be pulling the amounts from the income statement and balance sheet columns. Thats it!

What's left?

Once the financial statements are prepared, everything balances out, and all are happy, we must get those adjustments from the informal worksheet and into the formal accounting system. The hard part is done. All the calculations are done. All you have to do now is journalize the adjustments in the journal. They are handled in the same manner, except the word "Adjusting" is placed above the entries in the journal. They are also posted to the ledger in the same manner, except that you write in "adjusting" in the item column of the ledger.