Financial Accounting 13 - Adjusting Entries

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Bala Sir welcomed the ladies for the next session on 'Adjusting Entries'. He drew their attention to the Income and Expenditure statement they had prepared earlier for APS for the month of October 2021. It is reproduced below for convenience.

APS Income and Expenditure Statement for October 2021			
Income		Expenditure	
Sale of merchandise	240,000	Shop Rent expenses	1,000
		Depreciation expenses (F&F)	2,000
		Cost of Goods Sold (COGS)	180,000
		Electricity Bill	1,000
		Salaries expenses	7,500
		Self-service expenses	25,000
		Interest expense	3,400
		Sub-total	219,900
		Excess of Income over expenses	20,100
Total	240,000	Total	240,000

He asked them to examine this statement and try to identify the items for which they have already made journal entries, in the last class. One by one, the ladies pointed out the following transactions: Shop Rent expenses, Cost of Goods Sold (COGS), Electricity Bill, Salaries expenses and Self-service expenses. He then listed the two items left out: Depreciation expenses (F&F) and Interest expense. He posed a question to the ladies: "Why do you think we missed out on these two items, when we were making journal entries very systematically, by going over all the transactions, described in the text?" The women were at a loss, trying to figure out where they might have gone wrong. Some of them went over the case description again, but of no avail.

Vaishali hesitantly said, "Is it because these are sort of hidden expenses?" Bala Sir congratulated her, and then asked her to explain what did she mean by the term 'hidden'. Vaishali got some confidence, and talked about the Depreciation expenses (F&F). She said that as we use the furniture and fixture for our business, its useful life is consumed, but that happens silently, and we do not see any money going out. Bala Sir was very happy, and then he asked if someone else would like to explain the Interest expense on similar lines. Uma raised her hand, and explained that as days pass, interest on our bank loan accumulates *silently*, and even though APS had not actually paid the interest, it became due, and should be considered as an expense incurred over the month.

Bala Sir, congratulated the members for their insight, and started explaining 'Adjusting Entries'. He said that at the end of a period, when the accountants try to figure out the final result (profit or loss), they must try to identify all such hidden costs (and possibly revenues also) for running the business and book them appropriately. A common feature of all these Adjusting Entries is that they do not involve any cash transaction. Yet they need to be recorded or booked correctly. We shall now try to make journal entries and T Accounts for these two items.

First, Depreciation expenses (F&F). We have already seen how the depreciation expenses are calculated, using an estimated life of the fixed assets, applying a pro-rata basis of calculation. This is known as the 'Straight Line Method'. Please recall, we calculated the annual cost of using all furniture and fixtures as Rs. 24,000 and divided this by 12 to get the value for 1 month. Now we need to understand how the accountants keep track of these expenses through debits and credits. The debit is of course Depreciation expense, being an expense. *What is the credit entry? Here comes a convention followed in accounting – it is considered as an erosion or reduction in the value of the asset.* Please recall that this is an asset, and a decrease in the value of an asset is recorded as a credit entry. Therefore, we make the following

Journal entry:

Oct. 31, 2021 Depreciation expenses (F&F) Dr. Depreciation expenses (F&F) 2000
Cr. Furniture & Fixture 2000

Accounts

Depreciation expenses (F&F)	
Debit	Credit
2000 (AE-1)	
Closing balance	
2,000	

Furniture & Fixture	
Debit	Credit
120,000 (4)	2000 (AE-1)
Closing balance	
118,000	

Please note that, we had already created a T-account for Furniture and Fixture in our earlier transaction # 4. We simply insert the credit amount now.

Let us now take up the next item, interest expense. The debit entry is again easy to fix – it is an expense, and expenses going up means a debit entry. We are now faced with the same question, what is the corresponding credit entry? Bala Sir asked the ladies to try to figure it out. He encouraged them saying, "You have already dealt with it – just try to recall from your earlier statements." The ladies started flipping through their notes, and Urmila raised her hand asking 'Interest Payable'? Bala Sir was very happy, and asked her, how did you find it? She said that she looked at the Balance Sheet, and could relate the situation. Now he asked her to explain the entry. Urmila said, it is a liability, (RHS item), it is going up, therefore, the journal entry should be Cr. Interest Payable 3400. Bala Sir congratulated Urmila, and proceeded to record the following entries:

Journal entry:

Oct. 31, 2021 Interest expense Dr. Interest expense 3400

Cr. Interest Payable 3400

Accounts

Interest expenses	
Debit	Credit
3400 (AE-2)	
Closing balance	
3,400	

Interest Payable	
Debit	Credit
	3400 (AE-2)
Closing balance	
	3,400

Bala Sir now asked the ladies to make doubly sure, that they have correctly accounted for all items. For that, he suggested a systematic method. According to this method, we have to take up each item, and check if we have made any error. So, he took up the first item from the earlier APS Income and Expenditure Statement for October 2021. It was as follows:

Shop Rent expenses	1,000

Now Bala Sir asked them to check for this item in their journal entries. They found the following entries only, relating to shop rent:

Transaction 3: APS paid Rs. 12,000 in advance, as rental for one year on October $7^{th.}$

Journal entry:

3 Oct. 7, 2021 Shop rental advance Dr. Pre-paid rent 12,000

Cr. Cash 12,000

Everybody was feeling wrong. But Bala Sir assured them, not to worry, as he was a party to this mistake. He had also mixed-up Shop Rent Expenses and Shop Rental Advance. We had dealt with the advance, but we had not dealt with the expense part. Therefore, it was necessary to make another adjusting entry. Let us analyse the situation carefully. On October 7, we had paid an advance rent for 1 year, and thereby created an asset called prepaid rent, valued at 12,000. However, as we stand on the end of the month, we have already used up a month's worth of this value, simply by occupying the rented shop. Therefore, the value of this asset has gone down (credit entry!) by 1000. The corresponding debit entry should be recognised as Shop Rent Expense 1000. Therefore, we need to make the following journal entries and T-accounts:

Journal entry:

AE 3. Oct. 31 2021 Shop Rent expenses — Dr. Shop Rent expense 1,000

Cr. Pre-paid rent 1000

Accounts

Shop Rent expenses	
Debit	Credit
1000 (AE-3)	
Closing balance	
1,000	

Pre-paid rent	
Debit	Credit
12,000 (3)	1000 (AE-3)
Closing balance	
11,000	

Once again, you must note that for those T-accounts where we have made earlier entries, we must simply add the new entries. For fresh items, we create a new T-account.

Bala Sir asked them to form groups of two, (numbered I to V) and examine each one of the following entries made earlier, to be sure that they had done this correctly. An easy method for doing so, he told them, was to check the name of the account and the amount – the two critical elements of all entries. Vaishali, was in Gr. I and being the leader, she had two items to check.

Depreciation expenses (F&F)	2,000	Gr. I
Cost of Goods Sold (COGS)	180,000	Gr. II
Electricity Bill	1,000	Gr. III
Salaries expenses	7,500	Gr. IV
Self-service expenses	25,000	Gr. V
Interest expense	3,400	Gr. I

All of them confirmed that the entries were correct.

Bala Sir took this opportunity to explain to them the importance of being careful. He also told them that all such hidden expenses that accrue with the passage of time, are also known as 'Period Costs'.

Finally, Bala Sir asked them to take up each account, and insert two rows at the bottom for noting down the 'Closing Balance'. He explained that the Closing Balance is the net of all debits and credits at the end of the period, whichever is greater. He closed the day's session at this point, and invited them to come the next weekend.