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THE THEORY OF BOOK KEEPING AND ACCOUNTANCY

PART 4

FINAL ADJUSTMENTS

EXAMPLE 31:

In this example we simply take the Income and Expenditure Account and Balance Sheet as shown in Example 30 and make further necessary adjustments to these. In doing Example 30 we did, for the sake of simplicity, ignore these necessary adjustments, and now we simply go back and pick them up.

INCOME AND EXPENDITURE ACCOUNT

Let us look again at the debit side of the Income and Expenditure Account. As stated already, the debit entries should represent the expense of MEST and SERVICES actually used up in the Period. Now let us examine each debit account again to see if each Account does correctly show the amount of MEST or SERVICES actually used up in the Period.

PURCHASES OF BOOKS AND METERS

The expense of $1100.00 is made up of:

100 DMSMH	at cost $3.00	300.00
10 E-Meters	at cost $80.00	800.00
		1100.00

But the sales of Books and Meters were:

10 DMSMH
2 E-Meters

Therefore by simple arithmetic we know that we have a store or supply of E-Meters and Books in hand at 31 March of 90 DMSMH and 8 E-Meters.

This store or supply of Books and E-Meters is known as the Stock. Now this Stock does not represent MEST used up in the Period because, factually, it was not used up. It is still there and available for sale in the following Period. Therefore it is an ASSET. As such, the value of this Stock must come out of the Income and Expenditure Account and be placed in the Balance Sheet as an Asset.

Now let us work out the value of this Stock and use the cost price to work this out. We have:

STOCK

90 DMSMH at cost price $3.00	= 270.00
8 E-Meters at cost price $80.00	640.00
	910.00

If you look at the Income and Expenditure Account and Balance Sheet it is easy to see the effect of the entry we now need to make. You will see that we wish to reduce the Purchases of Books and Meters of $1100.00 by $910.00 and then show this $910.00 on the Balance Sheet as an Asset.

Now final adjustments of this nature are usually noted in a Note Book, before altering the BOOK KEEPING, so that a permanent record of the adjustments are kept in one place. This note book is called the Journal. The Journal records exactly the BOOK KEEPING entry that has to be made. The Journal entry is only a note; it then has to be entered into the Accounts concerned - exactly as written.

In this case the Journal note will be:

JOURNAL

	Debit	Credit
Journal 1. Stock Account	910.00	
Purchases of Books and Meters Account		910.00

The Stock Account debit entry of $910.00 appears as an Asset on the Balance Sheet. The credit entry of $910.00 is entered to Purchases of Books and Meters Account to reduce the cost of the BOOKs and Meters from $1100.00 to $910.00.

The Income and Expenditure Account will show this as follows:

Purchases of Books and Meters	1100.00	
Less: Stock in Hand at 31 March	910.00	190.00

By these entries therefore, we have reduced the Purchases of Books and Meters Account in the Income and Expenditure Account to $190.00 and shown the value of the Stock of $910.00 on the Balance Sheet.

WAGES

The wages figure of $80.00 on the Income and Expenditure Account is for salary for Silwell at the rate of $40.00 a month for January and February.

Therefore we can see that the Organization owes a further month's salary to this staff member for the month of March, i.e. a further $40.00.

In this case, the Wages figure of $80.00 does not fully reflect the value of the SERVICES received for the Period - it is $40.00 short. Further it is apparent that the Organization owed this amount of $40.00 to staff member Silwell.

Therefore if we now made an entry to increase wages by $40.00 to make a total of $120.00 and, at the same time, made an entry of a liability onto the Balance Sheet of $40.00, then we would have correctly stated the position.

The Journal note will be:

Journal 2. Wages Account	40.00	
Accrued Expenses		40.00

The Debit entry to Wages Account will increase the figure to $120.00; the Credit entry brings the liability onto the Balance Sheet.

Note that the credit entry has been made to an "Accrued Expenses Account" rather than Account for Silwell - although it could equally well have been made to an Account for Silwell.

"Accrued Expenses" simply means expenses for which the Organization is liable i.e. a liability Account.

Normally at the end of the Financial Period, the Organization has to enter many additional liabilities of the above nature and, rather than open individual Personal Accounts for all the Outside Persons concerned, it often lumps all such liabilities into an "Accrued Expanses Account". If this Account is regarded as a collective Personal Account for all the Outside Persons concerned then the matter will become clearer.

ELECTRICITY

The Electricity Account on the Income and Expenditure Account shows an amount of $70.00 but this only covers Electricity SERVICE for the months of January and February.

Thus the Account does not fully reflect the cost of SERVICES received in the Period since the service received in March is not yet entered.

Therefore, we have to make an estimate of what the cost of the SERVICE for March will be. Since the cost for two months supply was $70.00, then we estimate that the cost of the one month of March will be $35.00.

If we now make an entry to increase the Electricity Account by $35.00 and at the same time record the liability due to the Electricity Co., then we shall have corrected the situation. The Journal note is therefore:

Journal 3. Electricity Account	35.00	
Accrued Expenses Account		35.00

Note that the credit entry has again been made to "Accrued Expenses" Account - although it could equally well have been made to the Personal Account of the "Electricity Co.".

RATES

The Income and Expenditure Account shows an amount for Rates of $200.00. But we see that this $200.00 covers a six month period from January to June. In this instance, therefore, the Income and Expenditure Account records more than the value of the Rates SERVICES received in the Period i.e. it includes the cost of the SERVICE to be received by the Organization in the following period for the months of April, May and June.

In this instance, we have recorded the value of a SERVICE before it was received by the Organization - this is known as Prepayment. "Prepayment" means to pay an expense in advance.

A "Prepayment" is an Asset in that the Organization will not receive the benefit of the SERVICE until the following Period. Another way of demonstrating that this is an Asset is to consider that if the Organization closed down at 31st March, then it would receive a refund for the unexpired portion of rates.

The amount of the Prepayment in this case will be a $100.00 since this amount covers the unexpired months of April, May and June, i.e. one half of the six months period that has been recorded.

If we therefore reduce the Rates Account on the Income and Expenditure Account by $100.00 and, at the same time, show an Asset for this amount on the Balance Sheet then we shall have corrected the position.

The Journal Note will be:

Journal 4. Prepayments	100.00	
Rates Account		100.00

The debit entry to Prepayment Account will appear on the Balance Sheet as an Asset and the credit entry to Rates Account will reduce the Rates Account by $100.00.

We have now examined the Income and Expenditure Account amd made necessary adjustments to those Accounts. Now, let us examine the Assets on the Balance Sheet.

An Asset has already been defined as the value of something owned by the Organization at the end of the Financial Period.

We now look at the Assets recorded to see if they are worth the value of which they are recorded.

FURNITURE

This is recorded at the cost value of $500.00 and the consideration is whether it is worth this at 31st March.

The answer is no! The furniture has already been in use for three months from January to March and it will be considered to have lost value by reason of usage; this lost value is known as "Depreciation". Depreciation means a fall in value by reason of the wear and tear of usage or any other factor that reduces the value of an asset.

In BOOK KEEPING and ACCOUNTANCY the recording of Depreciation almost always has to be done by the use of some arbitrary method. The most common one for Assets such as furniture, equipment, motor cars, etc, is to estimate the useful life of the Asset and to depreciate the cost of the Asset equitably over this estimated period.

In this case, let us assume, the useful life of the furniture is estimated to be 5 years or 60 months.

In this period we have used the furniture for just three months and thus we can arbitrarily state that 3/60ths of the value has expired. This is calculated as follows:

3/60ths of cost price $500 = $25.00

This depreciation figure of $25.00 is then reckoned to be the value of the amount of furniture used up in the period. Therefore this usage must be entered into the Income and Expenditure Account as an expense since the Income and Expenditure Accounts records the value of MEST and SERVICES used up by the Organization in the period. In this case, it is the value of MEST used up.

At the same time we must reduce the value of the Asset shown in the Balance by $25.00 since otherwise it will be overstated in value to this amount.

Therefore the Journal Note is:

Journal 5. Depreciation Account	25.00	
Furniture Account		25.00

The debit entry shows as an expense on Income and Expenditure Account and the credit entry shows as a reduction of Furniture Account on the Balance Sheet. It is usual to show the reduction on the Furniture Account of the Balance Sheet as follows:

Furniture at cost	500.00	
Less: Depreciation	25.00	475.00

Debt due to the Organization - $100.00

Now let us examine the Debt due from Beal on the Balance Sheet of $100.00 and consider whether the value stated of $100.00 is correct.

If we are certain that Beal will pay this debt, then it is correct; if on the other hand, we have some doubt as to whether all or part of the Debt will be paid, then it can be considered to be overstated in value. In this case, we must provide for a possible "Bad Debt" - a "Bad Debt" simply means one that is not paid.

A Debt can be provided for either partially or wholly depending upon the degree of doubt that exists about the payment of it. One can only evaluate this by all the relevant circumstances.

In this case let us assume that we are slightly doubtful about Beal paying this debt and thus decide to make a provision of 50% - i.e. $50.00.

The Journal Note would be:

Journal 6.	Income and Expenditure Account (Provision for Bad Debts)	50.00	
	Provision for Bad Debts (Balance Sheet)		50.00

The debit entry goes into the Income and Expenditure Account and can be regarded as that part of an asset used up in much the same way as Depreciation. In this case, it is not the usage of the asset which has caused the depreciation - as in the case of furniture - but the financial status of Beal, and this has indicated a depreciation of the value of the debt.

Such a provision may turn out to be completely wrong since Beal may well pay the debt in full, but one can only work from the data available at the time of preparation of the Income and Expenditure Account and Balance Sheet. If the provision does turn out to be wrong, then an adjustment is always made in the subsequent financial period.

The credit entry is made to the Balance Sheet and has the effect of reducing the value of Beal's debt from $100.00 to $50.00. Since we consider the debt is only to be worth $50.00, then this is obviously correct.

The showing of the debt on the Balance Sheet now becomes:

Debt to the Organization	100.00	
Less: Provision for Bad Debt	50.00	50.00

SUMMARY

We have now made six Journal or adjusting entries and it is well to summarise what has been achieved by these.

Journal 1 - Stocks. This reduced the expense of Purchases of Books and Meters by $910.00 and brought this amount into the Balance Sheet as an Asset. As such it was an adjusting entry as between two Impersonal Accounts - i.e. Purchases of Books and Meters Account on one hand and Stock Account on the other. There was no INFLOW or OUTFLOW of MEST involved. It was simply an adjustment to differentiate between MEST used up and MEST not used up.

JOURNAL 2 AND 3 - WAGES AND ELECTRICITY

These Journals recorded the further INFLOW to the Organization for Wages SERVICES and ELECTRICITY SERVICES. The Organization's Impersonal Accounts of Wages and Electricity were debited to record the INFLOW and the Personal Accounts of Silwell and Electricity Co. were credited. However, instead of recording separate Personal Accounts for each one, a collective Personal Account was used for them both i.e. "Accrued Expenses Account".

JOURNAL 4 - RATES

This reduced the expense of Rates in the Income and Expenditure Account by $100.00 and brought this amount into the Balance Sheet as an Asset. In the same way that Stocks had not been used up in Journal 1 above so, in this case, SERVICES had not been used up. It is an adjusting entry as between two Impersonal Accounts - Rates Account on one hand and Prepayments Account on the other. There is no INFLOW or OUTFLOW of SERVICES involved; it is simply an adjustment to differentiate between SERVICES used up and SERVICES not used up.

JOURNAL 5 - FURNITURE

This entry brought into the Income and Expenditure Account the value of that part of the Asset - Furniture - which was considered to have been used up. At the same time, it reduced the value of the Asset in the Balance Sheet by this amount.

It is an adjusting entry between two Impersonal Accounts, i.e. Depreciation Account on one hand and Furniture Account on the other. There is no INFLOW or OUTFLOW of MEST involved. The entry is simply an adjusting one to differentiate as between that part of the Asset used up and that part of the Asset not used up.

JOURNAL 6 - DEBT DUE TO THE ORGANIZATION

In the same way as Depreciation, this entry merely differentiated as between that part of the Asset (i.e. Debt from Beal) considered to have been used up and that part of the asset which was considered not to have been used up. It was merely an adjusting entry. The debit entry to the Income and Expenditure Account reflected that part of the Asset used up and the credit entry to Balance Sheet was used to reduce the debt from Beal to what was considered to be its correct value. Again it was an adjusting entry as between two Impersonal Accounts, i.e. a debit to Provision for Bad Debts on the Income and Expenditure Account to record the cost of the Asset used up and a credit to Provision for Bad Debts Account on the Balance Sheet which is used to reduce the value of the debt from Beal.

We now have to alter the BOOK KEEPING as shown in Example 30 to record these six Journal entries numbered 1 to 6.

This is now done and then the Income and Expenditure Account and Balance Sheet is again prepared from the amended Accounts shown.

In recording these Journal entries, only those Accounts which are effected by them are shown below. Accounts which are not effected remain as in Example 30 and are brought into this Income and Expenditure Account and Balance Sheet as shown in that example.

Those Accounts which are effected by the Journal entries are shown below with any entries already made in Example 30 as well as the entries caused by the Journal adjustments. The Journal entries are entered with reference to the Journal number i.e. "Journal 1", etc.

IMPERSONAL ACCOUNTS

PURCHASES OF BOOKS AND METERS ACCOUNT

7.	12 Jan	Books & Meters received from Pubs Org	1100.00	31 Mar	Journal 1	910.00
					Transfer to Income & Expenditure A/C	190.00
			1100.00			1100.00

STOCK ACCOUNT

	31 Mar	Journal 1	910.00			

WAGES ACCOUNT

15.	31 Jan	Bank Account	40.00	31 Mar	Transfer to Income & Expenditure A/C	120.00
18.	28 Feb	"	40.00			
	31 Mar	Journal 2	40.00			
			120.00			120.00

ELECTRICITY ACCOUNT

19.	17 Mar	Electric Service received for Jan & Feb	70.00	31 Mar	Transfer to Income & Expenditure	105.00
	31 Mar	Journal 3	35.00			
			105.00			105.00

RATES ACCOUNT

6.	31 Jan	E.G.U.D.C. rates for six months to June	200.00	31 Mar	Journal 4	100.00
				31 Mar	Transfer to Income & Expenditure Account	100.00
			200.00			200.00

DEPRECIATION ACCOUNT

	31 Mar	Journal 5	25.00	31 Mar	Transfer to Income & Expenditure Account	25.00
			25.00			25.00

PROVISION FOR BAD DEBTS

(Income and Expenditure A/C)

31 Mar	Journal 6	50.00	31 Mar	Transfer to Income & Expenditure Account	50.00

FURNITURE ACCOUNT

11. 1 Jan	Furniture from Simons & Co.	500.00	31 Mar	Journal 5 Depreciation	25.00
			31 Mar	Balance	475.00
		500.00			500.00
31 Mar	Balance	475.00			

Note: It is quite usual for this Depreciation to be kept separately in its own Account. In this case, a balance of $500.00 would show on this Account and a separate Account would record the credit for the depreciation of $25.00 against it.

PREPAYMENTS

31 Mar	Journal 4	100.00

PROVISION FOR BAD DEBTS

(Balance Sheet)

			31 Mar	Journal 6	50.00

PERSONAL ACCOUNTS SUPPLIERS

ACCRUED EXPENSES ACCOUNT

			31 Mar	Journal 2 for Wages for Silwell	40.00
			31 Mar	Journal 3 for Electricity Co.	35.00
					75.00

The Income and Expenditure Account and Balance Sheet are now altered by the above adjustments to the following:

JOHN SMITH

INCOME AND EXPENDITURE ACCOUNT

FOR THE THREE MONTHS TO 31st MARCH

Purchases of Books and Meters	1100.00		Sales of Training and Processing	1000.00
Less: Stocks	910.00			
		190.00	Sales of Books and Meters	330.00

Wages	120.00	
Rates	100.00	
Rent	250.00	
Electricity	105.00	
Telephone	60.00	
Stationery	80.00	
Depreciation	25.00	
Provision for Bad Debts	50.00	
Profit for the Period	350.00	
	1330.00	1330.00

Balance Sheet — **As at 31 March**

Assets			Liabilities		
Furniture at cost	500.00		John Smith - Capital Account		
Less Depreciation	25.00		- Balance	1400.00	
		475.00	Add: Profit	350.00	
Balance at Bank		2180.00			1750.00
Debt due to the Organization	100.00		Amount due to Suppliers		1390.00
Less: Provision for Bad Debt	50.00	50.00	Accrued Expenses		75.00
Stock		910.00	Advance Payments		500.00
Prepayments		100.00			
		3715.00			3715.00

If you examine this Income and Expenditure Account and Balance Sheet and compare it to that shown in Example 30, then the adjustments made should become apparent.

Each of the adjustments made involved an interplay as between the Income and Expenditure Account on one hand and the Balance Sheet on the other.

If an Account on the Income and Expenditure Account was debited, then a corresponding credit entry was made to a Balance Sheet Account. If an Account on the Income and Expenditure Account was credited, then a corresponding debit was made to a Balance Sheet Account.

Each of these adjustments does alter the Profit or Loss shown for the Period and the final result is to show a profit for the Period of $350.00. Comparison of this with the loss of $510.00 shown in Example 30 emphasises the necessity for these correcting Journal entries.

This profit is brought down to the Balance Sheet and is added to the amount owed to the owner, John Smith. This is correct because the Organization is regarded as owing this amount to Smith.

The Balance Sheet will, obviously, balance out again, as shown, and in fact it is quite impossible for the Balance Sheet to fail to balance.

Every transaction in BOOK KEEPING is entered as to both a debit and a credit entry.

The Income and Expenditure Account and Balance Sheet include all the debit entries made and all the credit entries made. Since the Income and Expenditure Account merely summarises a section of the BOOK KEEPING and then carries its result to the Balance Sheet, then this letter sheet must obviously balance.

The carrying of the Profit or Loss (in this case a profit of $350.00) from the Income and Expenditure Account to the Balance Sheet does close off the entire Income and Expenditure Account for that period.

This whole section has been terminatedly handled and its result i.e. either profit or loss is then shown in the Balance Sheet where it represents either an asset or a liability as noted above.

Thus the only "Balances" left in the Accounts are those shown on the "Balance" Sheet. And BOOK KEEPING for the subsequent period commences with these "Balances".

Derek Field
Accountant WW

for
Herbie Parkhouse
D/Guardian Finance WW

for
Jane Kember
The Guardian WW

for
Mary Sue Hubbard
The Controller

Reissued as BPL
by Flag Mission 1234 2nd
Molly Gilliam

Approved by the
Commodore's Staff Aides
and the
Board of Issues

for the
BOARDS OF DIRECTORS
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DF:MG:mg