

CHAPTER .2

ADJUSTING ENTRIES

Introduction to Adjusting Entries:

Adjusting entries are accounting journal entries that convert a company's accounting records to the accrual basis of accounting. An adjusting journal entry is typically made just prior to issuing a company's financial statements.

The adjusting entries involve expenses, and revenues. Adjusting entries assure that both the balance sheet and the income statement are **up-to-date** on the accrual basis of accounting.

Adjusting entries occurs for the following reasons.

- 1. Some events are not journalized daily because it is not expedient. Examples are the consumption of supplies and the earning of wages by employees.**
- 2. Some costs are not journalized during the accounting period because these costs expire with the passage of time rather than as a result of recurring daily transactions. Examples of such costs are building and equipment deterioration and rent and insurance.**
- 3. Some items may be unrecorded. An example is a utility service bill that will not be received until the next accounting period.**

There are following types of adjusting entries:

1. Accruals:

These include revenues not yet received nor recorded and expenses not yet paid nor recorded. For example, interest expense on loan accrued in the current period but not yet paid.

2. Prepayments:

These are revenues received in advance and recorded as liabilities, to be recorded as revenue and expenses paid in advance and recorded as assets, to be recorded as expense. For example, adjustments to unearned revenue, prepaid insurance, office supplies, prepaid rent, etc.

3. Non-cash:

These adjusting entries record non-cash items such as depreciation expense, allowance for doubtful debts etc.

Another classification of Adjusting Entries:

Adjusting entries are classified as either deferrals or accruals:

Deferrals

1. **Prepaid Expenses.** Expenses paid in cash and recorded as assets before they are used or consumed.
2. **Unearned Revenues.** Revenues received in cash and recorded as liabilities before they are earned.

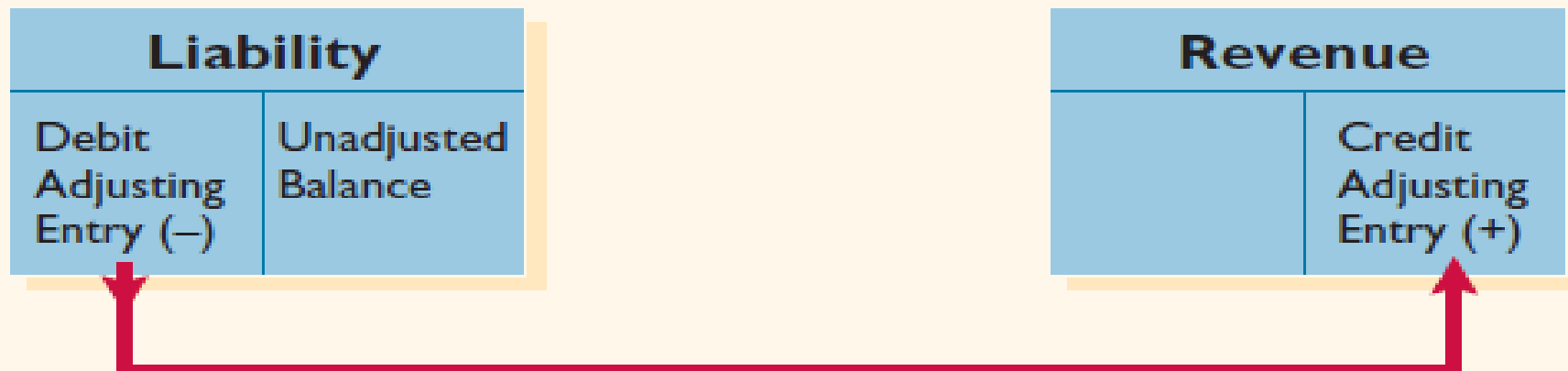
Accruals

3. **Accrued Revenues.** Revenues earned but not yet received in cash or recorded.
4. **Accrued Expenses.** Expenses incurred but not yet paid in cash or recorded.

Prepaid Expenses



Unearned Revenues



Accrued Revenues

Asset	
Debit Adjusting Entry (+)	

Revenue	
	Credit Adjusting Entry (+)

Accrued Expenses

Expense	
Debit Adjusting Entry (+)	

Liability	
	Credit Adjusting Entry (+)

Accrued Expenses:

An accrued expense is one that you incur but have not yet paid. An adjusting entry to record an accrued expense increases the expense account that corresponds to the expense incurred and increases the appropriate payable account.

A payable account shows the amount you owe other parties.

For example:

If your small business accrues a \$5,000 expense for salaries in the current period and will pay your employees in the next period. You add \$5,000 to the salaries expense account and to the salaries payable account in an adjusting journal entry.

Accrued/ payable Expenses:

Example 1:

For the month of December 2013, *Gray Network Services* used a total of \$1,800 worth of electricity and water. The company received the bills on January 10, 2014.

When should the expense be recorded, *December 2013 or January 2014?*

Example 2:

VIRON Company enters into a rental agreement to use the premises of DON's building. The terms state that VIRON will pay monthly rentals of \$1,500 at the end of every month. The lease started on December 1, 2013. On December 31, the rent for the month has not yet been paid and no record for rent expense was made.

Example 3:

VIRON Company borrowed \$6,000 at 12% interest on August 1, 2013. The amount will be paid after 1 year. At the end of December, the end of the accounting period, no entry was entered in the journal to take up the interest.

Accrued/ payable Expenses:

Example 1;

	date	Details	Debit	Credit
Dec	31	Utilities Expense	1,800	
		Utilities Payable		1,800

Example 2:

	date	Details	Debit	Credit
Dec	31	Rent Expense	1,500	
		Rent Payable		1,500

Example 3:

	date	Details	Debit	Credit
Dec	31	Interest Expense	300	
		Interest Payable		300

Prepaid/ Deferred Expenses

A deferred, or prepaid, expense is one for which you paid cash up front at an earlier date but which you have not yet incurred. As you incur the expense, you create an adjusting entry that increases the appropriate expense account and reduces the prepaid expense account.

For example:

If your small business prepaid \$1,000 for rent at the beginning of the month. You create an adjusting entry at the end of the month that adds \$1,000 to the rent expense account and reduces the prepaid rent account by \$1,000.

Prepaid Expenses:

Example 1:

On 31/8/2013, \$4,800 was paid for a two-year insurance policy. The journal entry on that day included a debit to Prepaid Insurance and a credit to Cash for \$4,800.

Prepaid Expenses:

Example 1:

	date	Details	Debit	Credit
Dec	31	Insurance Expense	800	
		Prepaid Insurance		800

Unearned /Deferred Revenues

Deferred, or unearned, revenue occurs when you receive cash up front for services you will provide in the future. As you provide the services to earn the revenue, you create an adjusting entry that increases the revenue account and reduces the unearned revenue account by the amount earned.

For example:

assume your small business collected \$100 at the beginning of the month to provide a monthly service. At the end of the month, you create an adjusting entry that adds \$100 to the revenue account and reduces unearned revenue by \$100.

Unearned Revenue

Example 1:

On 25/7/2013, a law firm and its client sign a contract and the client pays \$8,400 cash. The contract states the law firm will provide monthly legal services for 12 months, beginning on 1/8/2013. A regular journal entry is needed on 25/7/2013.

Unearned Revenue

Example 1:

	date	Details	Debit	Credit
Dec	31	Unearned Revenue	3500	
		Legal Fees Earned		3500

Accrued Revenues:

Accrued revenue occurs when you make a sale and collect payment at a later date. An adjusting entry to record accrued revenue increases the revenue account and the accounts receivable account by the amount of the sale.

Accounts receivable shows the amount customers owe you.

For example:

assume your small business sold a \$100 product in the current period and will collect payment in the next period.

You create an adjusting journal entry in the current period that adds \$100 to your revenue account and adds \$100 to accounts receivable.

Accrued /Receivable Revenues

Example 1:

On 31/12/2013, the accountant questions the managers and discovers that revenue of \$12,500 has been earned (the services have been provided) but the clients have not yet been billed.

Example 2:

On 1/10/2013, the company provides services of \$15,000 to a client. The client will not be able to pay for the services until 1/4/2014. Thus, the client signs a promissory note for 6 months. The note bears 6% annual interest.

Receivable Revenues

Example 1:

	date	Details	Debit	Credit
Dec	31/2013	Fees Receivable	12500	
		Service Revenue		12500

Example 2:

	date	Details	Debit	Credit
Dec	31/2013	Interest Receivable	225	
		Interest Revenue		225

