Step 4….Adjusting entries

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Definition and explanation:

Adjusting entries (also known as end of period adjustments) are journal entries that are made at the end of an accounting period to adjust the accounts to accurately reflect the revenues and expenses of the current period.

The preparation of adjusting entries is the fourth step of accounting cycle and comes after the preparation of unadjusted trial balance.

Companies that prepare their financial statements in accordance with United States Generally Accepted Accounting Principles (US-GAAP) and International Financial Reporting Standards (IFRS) usually prepare some adjusting entries at the end of each accounting period.

In this article, we shall first discuss the purpose of adjusting entries and then explain the method of their preparation with the help of some examples.

The purpose of adjusting entries:

According to accrual concept of accounting, revenue is recognized in the period in which it is earned and expenses are recognized in the period in which they are incurred. Some business transactions affect the revenue and expenses of more than one accounting period. For example, a service providing company may receive service fee from its clients for more than one period or it may pay some of its expenses for many periods in advance. All revenue received or all expenses paid in advance cannot be reported on the income statement of the current accounting period. They must be assigned to the relevant accounting periods and must be reported on the relevant income statements.

The purpose of adjusting entries is to assign appropriate portion of revenue and expenses to the appropriate accounting period. By making adjusting entries, a portion of revenue is assigned to the accounting period in which it is earned and a portion of expenses is assigned to the accounting period in which it is incurred. It ensures that only the relevant revenue and expenses are reported in the income statement of a particular accounting period and the financial statements have been prepared correctly in accordance with accrual concept of accounting.

When adjusting entries are made?

Adjusting entries are usually made at the end of an accounting period. They can however be made at the end of a quarter, a month or even at the end of a day depending on the accounting requirement and the nature of business carried on by the company.

Important!

In all the examples in this article, we shall assume that the adjusting entries are made at the end of each month.

Types and examples of adjusting entries:

Adjusting entries can be divided into the following four types.

(1). Adjusting entries that convert assets to expenses:

Some cash expenditures are made to obtain benefits for more than one accounting period. Examples of such expenditures include advance payment of rent or insurance, purchase of office supplies, purchase of an office equipment or any other fixed asset. These are recorded by debiting an appropriate asset (such as prepaid rent, prepaid insurance, office supplies, office equipment etc.) and crediting cash account. This procedure is known as postponement or deferral of expenses. An adjusting entry is made at the end of accounting period for converting an appropriate portion of the asset into expense.

Example

On January 01, 2015, the Moon company paid $9,000 as advance rent of the head office building to Mr. X for the first quarter of the of year. If the company makes adjusting entries on monthly basis, the relevant journal entries are given below:

Entry on January 01 when the advance payment of rent is made:

Date	Account Name	Debit	Credit
2015			
Jan. 01	Prepaid rent	9,000	
	Cash		9,000

Adjusting entry on January 31 to convert a portion of prepaid rent (an asset) to rent expense:

Date	Account Name	Debit	Credit
2015			
Jan. 31	Rent expense	*3,000	
	Prepaid rent		3,000

*9,000/3

As the $9,000 advance payment of rent is for a full quarter (i.e., three months), the adjusting entry made on January 31 will also be made at the end of the next two months (i.e., at the end of February and March).

(2). Adjusting entries that convert liabilities to revenue:

Sometime companies collect cash for which the goods or services are to be provided in some future period. Such receipt of cash is recorded by debiting cash and crediting a liability account known as *unearned revenue account*. This procedure is known as postponement or deferral of revenue. At the end of accounting period the unearned revenue is converted into earned revenue by making an adjusting entry for the value of goods or services provided during the period.

Example:

The Moon company receives $180,000 cash from Mr. Y (a client of the company) on January 01, 2015. At the end of January, the total value of the services provided to Mr. Y is $15,000. If accounts are adjusted at the end of each month, the relevant journal entries are given below:

Entry on January 01 when advance payment is received:

Date	Account Name	Debit	Credit
2015			
Jan. 01	Cash	180,000	
	Unearned revenue		180,000

Adjusting entry on January 31 to convert a portion of unearned revenue (a liability) to earned revenue:

Date	Account Name	Debit	Credit
2015			
Jan. 31	Unearned revenue	15,000	
	Client revenue		15,000

(3). Adjusting entries for accruing unpaid expenses:

Unpaid expenses are expenses which are incurred but no cash payment is made during the period. Such expenses are recorded by making an adjusting entry at the end of accounting period. It is known as accruing the unpaid expenses.

Example:

The Moon company pays salary to its employees on fifth day of every month. The total salary payable for the month of January is $8,500. If Moon company makes adjusting entries at the end of each month, it will record the following adjusting entry on January 31:

Adjusting entry on January 31:

Date	Account Name	Debit	Credit
2015			
Jan. 31	Salaries expense	8,500	
	Salaries payable		8,500

(4). Adjusting entries for accruing uncollected revenue:

Uncollected revenue is the revenue that is earned but not collected during the period. Such revenue is recorded by making an adjusting entry at the end of accounting period. It is known as accruing the uncollected revenue.

Example:

The Moon company provides services valuing $34,000 to Mr. Z during the month of January. Mr. Z will be billed next month. The company will record this accrued revenue by making the following adjusting entry:

Adjusting entry on January 31:

Date	Account Name	Debit	Credit
2015			
Jan. 31	Accounts receivable	34,000	
	Client revenue		34,000

After preparing all necessary adjusting entries, they are either posted to the ledger accounts or directly added to the unadjusted trial balance for the purpose of preparing adjusted trial balance of the company. Click on the next link below to understand how an adjusted trial balance is prepared.