

Visual Learning Maps

Introductory Financial Accounting



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VIRTUAL TEXT BOOK

ADJUSTING ENTRIES – page 1 of 9

When?

It is unusual to begin a topic by explaining "When" rather than "What" or "Why," however, Adjusting Entries are so critically important to the quality of the financial statements; the when part is first.

"Adjusting Entries" are made every accounting period; whether the business uses a month, quarter or year - these entries must be made or the financial statements will not be accurate.

Why?

In a business there is much transaction activity - sales are being made, bills are being paid, invoices are received and invoices are being issued. Cash is moving in and out, credit is being used and credit is being given - on account transactions. All of these are called "economic events."

There are also economic events occurring that are **not** creating entries from the external transaction universe; so they must be generated internally - these are formally referred to as Adjusting Entries. They are driven by the logic of these **Generally Accepted Accounting Principles**:

- Time Period must be defined for measurement (month, quarter, year)
- Revenue must be recognized when it is earned
- Matching - expense must be matched to revenue for the defined time period

Accuracy Objective

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What Are They, Broadly?

Adjusting Entries are about time passing, timing realities & changed facts:

Time Has Passed...

- ...The assets have aged. This fact must be recorded - this is adjusting for depreciation or amortization
- ...The business paid for things in advance, but that was then and this is now - prepaid items must be adjusted
- ...Work has been performed for customers /clients who paid in advance; therefore revenue and the liability of the business has decreased - this is adjusting unearned revenue

Timing Realities...

- ...Money is owed to employees for the period between the last payday and the month end date - this is accruing the payroll liability
- ...Relevant paperwork was not complete or received at month end. Money is owed to the business by customers, and money is owed by the company to suppliers; neither has been recorded - this is the accruing revenue and expense

The Fact Is That...

- ...The amount and value of supplies on hand this month end is different from last month because more supplies were bought since then, and some were used - this is adjusting the supplies account

Next are the SPECIFICS...

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What Are They, Specifically?

Recording Depreciation / Amortization

As time passes, all Property, Plant & Equipment (except land) lose their value; and the financial statements must reflect this. Therefore, depreciation expense is recorded, a debit. The credit side of the entry goes to a contra account of the asset category of PP&E. **Always.**

Account Balances Before The Entry	<u>Debit</u>	<u>Credit</u>
Equipment (asset)	\$ 120,000	
Accumulated depreciation (the net is 120,000)		0
Depreciation expense	0	

The Entry	<u>Debit</u>	<u>Credit</u>
Depreciation expense	5,000	
Equipment -accumulated depreciation		5,000

Account Balances After The Entry		
Equipment	120,000	
Accumulated depreciation (the net is 115,000)		5,000
Depreciation expense	5,000	

The effect of this Adjusting Entry is to increase expense and decrease the value of the asset - and this reflects reality. Readers of the financial statements now have an updated view of 1) valuation of the asset and 2) operating expense.

**To See How Depreciation is Calculated - see Class Notes
"Depreciation Methods"**

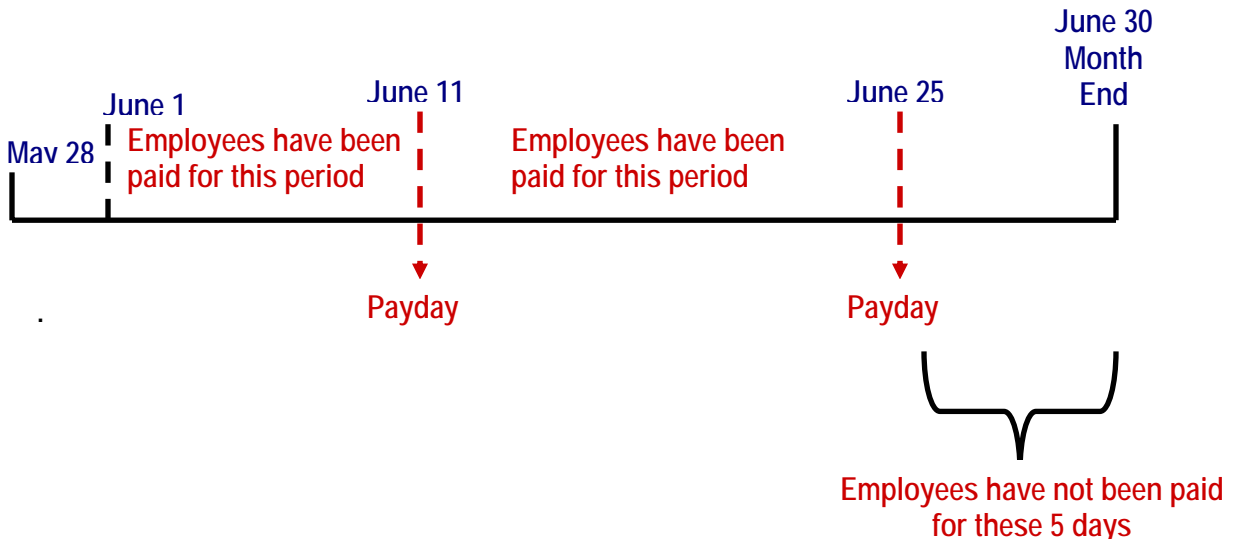
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What Are They, Specifically?...continued

Accruing the Payroll Liability

There are generally two types of payroll operations - semi-monthly; twice a month, at the middle and at the end; and bi-weekly, every two weeks. The semi-monthly basis always coincides with month ends, as do the accounting measurement periods - be it month, quarter or year. Therefore no accrual entry is necessary.

Accrual entries must be made for bi-weekly payrolls when the pay date and the month, quarter, or year end are on different days - this is almost always.



The above diagram shows why the Adjusting Entry must be made. The business owes five days payroll to the employees. If this is not recorded, liabilities will be too low (understated); and expense will be understated which means that net income will be too high (overstated).

The entry is **always** like this:

The Entry	Debit	Credit
Wage expense	3,000	
Wages payable		3,000

Liabilities and expense have increased. Without this entry, liabilities and expense would be understated, and net income would be overstated.

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What Are They, Specifically?...continued

Accruing Expense / Accounts Payable

This entry relates to paperwork and timing. At the beginning of the month following the month end, invoices are often received from suppliers that relate to the previous month, but it is too late to input them, or there is not enough time to process the invoices before the month end reports are generated.

Therefore the invoices from suppliers are quickly summarized and an accrual entry is made.

For example, the following invoices pertaining to May were received on June 6, too late to input to the May month end because the reports have already been generated. The May financial statements are due to be issued on June 10.

- Phone bill \$280
- Invoice for air fares \$980
- Electric bill \$785
- Water bill \$115
- Invoice for plumbing repairs \$ 2,500
- Invoice for ceiling repairs \$1,200

The entry is **always** like this:

The Entry	<u>Debit</u>	<u>Credit</u>
Telephone expense	280	
Travel expense	980	
Utilities expense	900	
Repairs expense	3,700	
Accounts payable		5,860

Without this entry, liabilities and expense would be understated, and net income would be overstated.

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What Are They, Specifically?...continued

Accruing Revenue / Accounts Receivable

This entry also relates to paperwork and timing. At the beginning of the month following the month end, invoices are issued to customers that relate to the previous month, but it is too late to input them, or there is not enough time to process the invoices before the month end reports are generated.

Therefore the invoices to customers are quickly summarized and an accrual entry is made.

For example, the following invoices pertaining to May were issued to customers on June 6, too late to input to the May month end because the reports have already been generated. The May financial statements are due to be issued on June 10.

- Invoice for services to M & R Company \$25,300
- Invoice for services to J & K Inc.

The entry is **always** like this:

The Entry	<u>Debit</u>	<u>Credit</u>
Accounts receivable	25,300	
Revenue		25,300

Without this entry, assets and revenue would be understated, and net income would be understated.

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What Are They, Specifically?...continued

Adjusting Prepaid Items

Prepaid accounts are current assets that record the money paid by the business to a supplier that relates to more than one accounting period.

Insurance policies can be paid for one, two or three years in advance. Rent or lease amounts are sometimes paid for six months to two years in advance.

But as time passes, the prepaid asset becomes an expense. The two year insurance policy paid on, say January 1st, is no longer prepaid for two years on December 31st - only one year is prepaid on December 31st. Therefore an Adjusting entry is required.

Example: On June 1st M & J Company paid \$2,400 to V & T Insurance inc. for a two-year liability and fire insurance policy the office building.

When the check is issued, there is a balance in the Prepaid Insurance account of \$2,400.

At June month end M & J must make an Adjusting Entry to record the passage of one month's time. This means that one month of the 24 month policy has expired.

1/ 24 of the \$2,400 is no longer an asset and must be sent to expense.

The Entry	<u>Debit</u>	<u>Credit</u>
Insurance expense	100	
Prepaid insurance		100

The effect of the Adjusting Entry is to decrease the asset and increase expense. The balance in the Prepaid account is now correct at \$2,300.

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What Are They, Specifically? Prepaid items...continued

Twists on Tests and Exams

- In the example, the expired amount is calculated from the facts; sometimes the expired amount is given; sometimes the correct closing balance is given
- Sometimes the data are given in years (e.g. 2 year policy), but the calculation needs to be in months so...
- Be sure of the number of months you are counting; are the financial statements for one month, a quarter (3 months) or one year (12 months)?

What Are They, Specifically? Adjusting Supplies

At the beginning of the accounting period there was a specific balance in the Supplies account. That balance was based on a physical count of the supplies on the month end date. Since then, more supplies have been purchased and supplies have been used. So what is the correct balance of Supplies?

To get that answer, another count is taken at this month end.

Example: In preparing the July financial statements the physical count of supplies on July 31st was determined to be \$650. The balance in the supplies account before adjustments is \$500.

The Entry	<u>Debit</u>	<u>Credit</u>
Supplies expense	150	
Supplies		150

Twists on Tests and Exams

- The phrase "The balance in the supplies account before adjustments" means the same as the "unadjusted trial balance figure."
- "The balance in" means the same as "on hand."

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What Are They, Specifically? Supplies...continued

- Sometimes questions will give the "amount of supplies used." This is recorded directly to expense and Supplies as the above entry shows.
- As in the above example, sometimes questions will provide the given data for the balance in the Supplies account and what the balance should be. In these cases, you must subtract to get the amount of Supplies used, and then record the entry as above.

The **adjustment** amount is **ALWAYS** the amount of **Supplies Used** - sometimes it is given; sometimes you calculate it

Adjusting Unearned Revenue

Reminder: "Unearned Revenue" is a current liability.

It represents money the business has received from a customer / client, but has not yet performed work for the customer / client to earn the money. Unearned revenue arises from deposits required for merchandise, rent, advance payments on contracts and retainers.

From one accounting period to another, the amount in the unearned revenue account must be adjusted because work has been performed during the accounting period.

Example: On June 1st M & J Company receives a retainer from JR Inc. for \$2,500. It was recorded to unearned revenue. During June M & J company performed work for JR Inc. in the amount of \$1,100.

The Entry	<u>Debit</u>	<u>Credit</u>
Unearned revenue	1,100	
Revenue		1,100

This entry records the fact that revenue has been earned and the liability has decreased during the month. Without this entry, liabilities would be overstated and revenue would be understated, thus understating net income.

Twists on Tests and Exams

- Sometimes the given is the amount earned (record directly as above); sometimes the given is the unadjusted balance and what the balance should be (calculation need)

ALWAYS record the **amount earned** during the period as above