Adjusting Entries

(Cheat Sheet)

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Why Adjusting Entries are Necessary

Adjusting entries are required at the end of each accounting period so that a company's financial statements reflect the accrual method of accounting. Without adjusting entries, a corporation's financial statements will likely report incorrect amounts of revenues, expenses, gains, losses, assets, liabilities, and stockholders' equity.

Common Characteristic of Adjusting Entries

Every adjusting entry will involve:

- At least one balance sheet account, *and*
- At least one income statement account

Therefore, if a required adjusting entry is omitted, both the company's balance sheet and its income statement will not report the correct amounts.

Adjusting entries are usually dated as of the final day of the accounting period.

As is the case with all journal entries, every adjusting entry must have debit amounts equal to the credit amounts.

Types of Adjusting Entries

Adjusting entries are often categorized as follows:

- Accruals
- Deferrals
- Others

Accruals (or accrual-type adjusting entries) refer to the adjusting entries that must be recorded prior to issuing the financial statements because a business transaction occurred, but it is not yet recorded in the company's general ledger. Two examples are:

- Electricity and gas used by the company in June but not billed by the utility until July
- Wages earned by hourly paid employees, but not processed until the following week

Without the accrual adjusting entries for these examples, the company's balance sheet will report too little in liabilities and too much in stockholders' equity, and the income statement will report the incorrect amount of expenses.

Deferrals (or deferral-type adjusting entries) refer to the adjustments needed because an amount that was recorded in the general ledger pertains to one or more future accounting periods.

To illustrate, assume that on December 1, a company recorded its $2,400 payment for six months of property insurance for December through May. At December 31, one month of the insurance cost (1/6 of $2,400) has expired and should be reported on its December income statement as Insurance Expense of $400. The remaining $2,000 of unexpired insurance (5 months X $400) must be reported on the December 31 balance sheet as a current asset such as Prepaid Insurance or Prepaid Expenses. In effect the unexpired cost of $2,000 is being deferred until it becomes Insurance Expense in January through May. All of this will be achieved through a series of deferral adjusting entries.

Others include the adjusting entries to record depreciation, bad debts, and adjustments for valuing some investments.

Typical Accruals

The following table shows the balance sheet account and the related income statement account for some typical *accruals*. (Recall that accruals are necessary so that all of a company's assets, liabilities, revenues, expenses, and losses are included in the appropriate financial statements.)

Balance Sheet Account		Income Statement Acct
Account Title	Type	Account Title
Wages Payable	Liability	Wages Expense
Interest Payable	Liability	Interest Expense
Utilities Payable	Liability	Utilities Expense
Repairs Exp Payable or Accrued Exp Payable	Liability	Repairs Expense
Interest Receivable	Asset	Interest Income

Example of Accrual Entry. On the final day of the accounting period, a corporation had an emergency repair of its heating system. The heating contractor told the corporation that the repair bill will be $3,000 and that an invoice will be sent in the corporation's next accounting period. Before the current period's financial statements are distributed the corporation must record an adjusting entry to accrue the $3,000 expense and liability. The journal entry will debit $3,000 to Repairs Expense, and will credit $3,000 to Accrued Expenses Payable. Without this adjusting entry the income statement would show net income which will be too high, the balance sheet will report liabilities which will be too low, and stockholders' equity which will be too high.

Typical Deferrals

The following table shows the accounts involved in some typical *deferrals*. (Recall that the adjusting entries for deferrals are necessary because some of the amounts in the general ledger accounts belong on the income statement of a future accounting period. Those amounts must be reported on the balance sheet dated for the end of the current accounting period.)

Balance Sheet Account		Income Statement Acct
Account Title	Type	Account Title
Prepaid Insurance	Asset	Insurance Expense
Supplies	Asset	Supplies Expense
Deferred Revenues	Liability	Revenues

Example 1 of Deferral Entry on December 31. On December 1, a company paid $2,400 for the cost of its property insurance for the 6-month period beginning on December 1. *The entire $2,400 was charged/debited to Insurance Expense*. On December 31 (the end of its accounting year) an adjusting entry will be needed to defer $2,000 (5 months X $400 per month): Prepaid Insurance will be debited for $2,000 and Insurance Expense will be credited for $2,000. After the December 31 adjusting entry, the debit balance in the asset account Prepaid Insurance will be $2,000; and Insurance Expense will have a debit balance of $400.

In each of the next 5 months, adjusting entries will be needed to debit Insurance Expense for $400 and to credit Prepaid Insurance for $400.

Example 2 of Deferral Entry on December 31. On December 1, the company paid $2,400 for the cost of its property insurance for the 6-month period beginning on December 1. *The entire $2,400 was charged/debited to the asset account Prepaid Insurance*. On December 31 (the end of its accounting year) an adjusting entry will be needed to move $400 ($2,400 divided by 6 months) from Prepaid Insurance to expense: Insurance Expense will be debited for $400 and Prepaid Insurance will be credited for $400. After the December 31 adjusting entry, the asset account Prepaid Insurance will have a debit balance of $2,000.

In each of the next 5 months, adjusting entries will be needed to debit Insurance Expense for $400 and to credit Prepaid Insurance for $400.

Other Adjusting Entries

The following table shows the balance sheet account and the related income statement account for two of the adjusting entries described as *other*.

Balance Sheet Account		Income Statement Acct
Account Title	Type	Account Title
Accumulated Depreciation	Contra Asset	Depreciation Expense
Allowance for Doubtful Accts	Contra Asset	Bad Debts Expense

Helpful Process for Preparing Adjusting Entries

Accountants often use "T" accounts to visualize the effect of a journal entry on the two (or more accounts) that are involved. Recall that the double-entry system requires the debit amounts to be equal to the credit amounts. The left side of one "T" will show the debit amounts, while the right side of another "T" will show the credit amounts.

Our helpful process for preparing adjusting entries has the following steps:

1. Draw two T-accounts, since every entry requires a minimum of two accounts.
2. Indicate the account titles on the horizontal part of each "T". For every adjusting entry there must be a balance sheet account and an income statement account.
3. Enter the balance prior to the adjusting entry in each of the T-accounts.
4. Determine the correct ending/final account balance for the balance sheet account.
5. Record an adjustment so that the ending amount in the balance sheet account is the correct amount from Step 4.
6. Enter the same adjustment amount into the related income statement account.
7. Write the adjusting journal entry.

Reversing Entries

Reversing entries are typically used in conjunction with the accruals. The reason is that shortly after the current period's financial statements are distributed, the company will receive the paperwork for the transactions that had been accrued. For example, if a company had accrued a repair expense that occurred at the end of the accounting period, the company will be receiving the vendor's invoice in the early part of the next accounting period. Similarly, if a company had accrued wages that had been earned near the end of the accounting period, the company will be processing its payroll a few days into the next accounting period. These two examples could result in a double recording (once with the adjusting entry and once with the actual billing transaction or the routine payroll entries that will be processed early in the next accounting period).

To avoid the risk of double-recording, *reversing entries are processed on the first day of the next accounting period* to remove the accrual adjusting entries. To illustrate, let's assume that on December 30 a retailer had an emergency repair of its heating system. The work was done on December 30 but the bill doesn't arrive prior to the preparation of the financial statements. As a result, the retailer recorded an accrual adjusting entry dated December 31 which debited Repairs Expense for $3,000 and credited the liability account Accrued Expenses Payable for $3,000. In order to avoid the risk of double-recording, the company will record a reversing entry dated January 1 (the first day of the next accounting period) that debits Accrued Expenses Payable for $3,000 and credits Repairs Expense for $3,000. This will result in a $0 balance in Accrued Expenses Payable and an unusual credit of $3,000 in Repairs Expense.

On January 10, the heating contractor's invoice is received and is approved for payment on January 20. Because a reversing entry was recorded on January 1, the company can record the contractor's invoice on January 10 with the usual debit to Repairs Expense and a credit to Accounts Payable. After the contractor's invoice is recorded, the balance in Repairs Expense for the new accounting period will be $0 (the credit of $3,000 on January 1 and the debit of $3,000 on January 10) and the balance in Accounts Payable that pertains to the repair will be $3,000. When the company pays the contractor on January 20, the company will debit Accounts Payable and will credit Cash for $3,000. *In short, the use of reversing entries eliminates any special handling of the vendor invoices*.