

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:

- the electricity and gas used by the company in June but not billed or paid until July
- the wages earned by hourly paid employees, but not processed or paid until the following week

Without the accrual adjusting entries for both of 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 necessary because an amount that had already been recorded in the general ledger pertains to several accounting periods including the current accounting period.

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 recording of 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 will appear on the 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 within a few days. Before the 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 will show net income which will be too high and 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. Therefore, 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 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, a deferral adjusting entry is 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 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, a deferral adjusting entry is 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 we use a double-entry system and the debit amounts must be equal to the credit amounts. The left side of the “T” will be used to see/show the debit amounts, while the right side of the “T” will be used to see/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.

Let's illustrate this with our Example 1 under "Typical Deferrals". The two related T-accounts are the balance sheet account Prepaid Insurance and the income statement account Insurance Expense (Step 2). Let's assume that the December 1 payment was the first time that the company had insurance and that the company's accounting period ends on December 31. Therefore, the balances in the two accounts were -0- prior to the December 1 payment. After the December 1 payment, the balance sheet account Prepaid Insurance will have a balance of -0- and the income statement account Insurance Expense will have a debit balance of \$2,400 (Step 3). Step 4 requires us to compute the balance needed as of December 31 in Prepaid Insurance. The amount needed is a debit balance of \$2,000 ($\400×5 months). Therefore, the adjustment needed in Prepaid Insurance is a debit of \$2,000 in order to go from -0- to a debit balance of \$2,000. Step 6 requires that \$2,000 be entered as a credit in the income statement account Insurance Expense. This will reduce the previous debit of \$2,400 in Insurance Expense to become a debit balance of \$400. Therefore, the adjusting entry for Step 7 is a debit to Prepaid Insurance of \$2,000 and a credit to Insurance Expense of \$2,000.

On January 31, the balance needed in Prepaid Insurance will be \$1,600 ($\$400 \times$ the remaining 4 months of February, March, April, May). Since the account balance is \$2,000 from December 31, a *credit* of \$400 should be entered in Prepaid Insurance as of January 31 to bring its debit balance down to the needed balance of \$1,600. Therefore, a *debit* of \$400 must also be entered in Insurance Expense.

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 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 must record an accrual adjusting entry dated December 31 which debits Repairs Expense for \$3,000 and credits 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 on January 1 (the first day of the next accounting period) that will debit Accrued Expenses Payable for \$3,000 and will credit 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 received in early January.*