Accounting Fundamentals Lesson 3

3.0 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.

Example for the need for an accounting adjusting entry:

Let's assume that a company borrowed money from its bank on December 1, 2013 and that the company's accounting period ends on December 31.

The bank loan specifies that the first interest payment on the loan will be due on March 1, 2014. This means that the company's accounting records as of December 31 do not contain any payment to the bank for the interest the company incurred from December 1 through December 31. (Of course the loan is costing the company interest expense every day, but the actual payment for the interest will not occur until March 1.)

For the company's December income statement to accurately report the company's profitability, it must include all of the company's December expenses not just the expenses that were paid.

Similarly, for the company's balance sheet on December 31 to be accurate, it must report a liability for the interest owed as of the balance sheet date. An adjusting entry is needed so that December's interest expense is included on December's income statement and the interest due as of December 31 is included on the December 31 balance sheet.

The adjusting entry will: debit Interest Expense and credit Interest Payable for the amount of interest from December 1 to December 31.

Another situation requiring an adjusting journal entry arises when an amount has already been recorded in the company's accounting records, but the amount is for more than the current accounting period.

Let's assume that on December 1, 2013 the company paid its insurance agent $2,400 for insurance protection during the period of December 1, 2013 through May 31, 2014.

The $2,400 transaction was recorded in the accounting records on December 1, but the amount represents six months of coverage and expense.

By December 31, one month of the insurance coverage and cost have been used up or expired. The income statement for December should report just one month of insurance cost of $400 ($2,400 divided by 6 months) in the account Insurance Expense.

The balance sheet dated December 31 should report the cost of five months of the insurance coverage that has not yet been used up. (The cost not used up is referred to as the asset Prepaid Insurance. The cost that is used up is referred to as the expired cost Insurance Expense.)

This means that the balance sheet dated December 31 should report five months of insurance cost or $2,000 ($400 per month times 5 months) in the asset account Prepaid Insurance. Since it is unlikely that the $2,400 transaction on December 1 was recorded this way, an adjusting entry will be needed at December 31, 2013 to get the income statement and balance sheet to report this accurately.

There are two scenarios where adjusting journal entries are needed before the financial statements are issued:

1. Nothing has been entered in the accounting records for certain expenses or revenues, but those expenses and/or revenues did occur and must be included in the current period's income statement and balance sheet.

2. Something has already been entered in the accounting records, but the amount needs to be divided up between two or more accounting periods.

Adjusting entries almost always involve a:

- Balance sheet account (Interest Payable, Prepaid Insurance, Accounts Receivable, etc.)
- Income statement account (Interest Expense, Insurance Expense, Service Revenues, etc.)

Adjusting entries are often sorted into two groups: accruals and deferrals.

3.1 Accrual Accounting

What are accruals?

Accruals are adjustments for:

1) Revenues that have been earned but are not yet recorded in the accounts,
2) Expenses that have been incurred but are not yet recorded in the accounts.

The accruals need to be added via adjusting entries so that the financial statements report these amounts.

Accrual of Expenses

An accountant might say, "We need to accrue the interest expense on the bank loan."

This is because nothing had been recorded in the accounts for interest expense, but the company did incur interest expense during the accounting period.

Further, the company has a liability or obligation for the unpaid interest up to the end of the accounting period. What the accountant is saying is that an accrual-type adjusting journal entry needs to be recorded.

The accountant might also say, "We need to accrue for the wages earned by the employees on Sunday, December 30, and Monday, December 31."

This means that an accrual-type adjusting entry is needed because the company incurred wages expenses on December 30-31 but nothing will be

entered routinely into the accounting records by the end of the accounting period on December 31.

A third example is the accrual of utilities expense.

Utilities provide the service (gas, electric, telephone) and then bill for the service they provided based on some type of metering.

The company will incur the utility expense before it receives a bill and before the accounting period ends.

An accrual-type adjusting journal entry must be made in order to properly report the correct amount of utilities expenses on the current period's income statement and the correct amount of liabilities on the balance sheet.

Accrual of Revenues

Accountants also use the term "accrual" or state that they must "accrue" when discussing revenues.

An accountant might say, "We need to accrue for the interest the company has earned on its certificate of deposit."

The company probably did not receive any interest nor did the company record any amounts in its accounts, but the company did indeed earn interest revenue during the accounting period. The company has the right to the interest earned and will need to list that as an asset on its balance sheet.

Example of an accrual for revenue involves your electric utility company:

The utility used coal and many employees in December to generate electricity that customers received in December. However, the utility doesn't bill the electric customers for the December electricity until the meters are read in January.

To have the proper amounts on the utility's financial statements, there needs to be an adjusting entry to increase revenues that were earned in December and the receivables that the utility has a right to as of December 31.

Deferrals - Something has already been entered in the accounting records, but the amount needs to be divided up between two or more accounting periods.

Deferrals or deferral-type adjusting entries can pertain to both expenses and revenues

Deferral of Expenses

Defer insurance expense:

The company paid on December 1 the entire bill for the insurance coverage for the six-month period of December 1 through May 31.

However, as of December 31 only one month of the insurance is used up. Hence the cost of the remaining five months is deferred to the balance sheet account Prepaid Insurance until it is moved to Insurance Expense during the months of January through May.

If the company prepares monthly financial statements, a deferral-type adjusting entry may be needed each month in order to move one-sixth of the six-month cost from the asset account Prepaid Insurance to the income statement account Insurance Expense.

Defer some of the cost of supplies:

This deferral is necessary because some of the supplies purchased were not used or consumed during the accounting period.

An adjusting entry will be necessary to defer to the balance sheet the cost of the supplies not used, and to have only the cost of supplies actually used being reported on the income statement.

The costs of the supplies not yet used are reported in the balance sheet account Supplies and the cost of the supplies used during the accounting period are reported in the income statement account Supplies Expense.

Deferral of Revenues

Deferrals also involve revenues. For example if a company receives $600 on December 1 in exchange for providing a monthly service from December 1 through May 31, the accountant should "defer" $500 of the amount to a liability account Unearned Revenues and allow $100 to be recorded as December service revenues.

The $500 in Unearned Revenues will be deferred until January through May when it will be moved with a deferral-type adjusting entry from Unearned Revenues to Service Revenues at a rate of $100 per month.

Depreciation

The reported amounts on a balance sheet for assets such as equipment, vehicles, and buildings must be routinely reduced by depreciation.

Depreciation is used for assets whose life is not indefinite—equipment wears out, vehicles become too old and costly to maintain, buildings age, and some assets (like computers) become obsolete.

Depreciation is the allocation of the cost of the asset to Depreciation Expense on the income statement over its useful life.

Depreciation expense - The income statement account, which contains a portion of the cost of plant and equipment that is being depreciated.

(There is no depreciation expense for land.)

Example: Assume that Direct Delivery's van has a useful life of five years and was purchased at a cost of $20,000.

The accountant might match $4,000 ($20,000 ÷ 5 years) of Depreciation Expense with each year's revenues for five years.

Each year the book value amount of the van will be reduced by $4,000. (The "book value"—is reported on the balance sheet and it is the cost of the van minus the total depreciation since the van was acquired.)

This means that after one year the balance sheet will report the book value amount of the delivery van as $16,000, after two years the book value will be $12,000, etc. After five years (the end of the van's expected useful life) its book value is zero.

Long-term assets (such as buildings, equipment, and furnishings) are reported at their cost minus the amounts already sent to the income statement as Depreciation Expense.

The balance sheet reports only the assets acquired and only at the cost reported in the transaction. This means that a company's reputation—as excellent as it might be—will not be listed as an asset.

Liabilities - obligations of the company; they are amounts owed to others as of the balance sheet date.

A liability can be money received in advance of actually earning the money.

Example: suppose that Direct Delivery enters into an agreement with one of its customers stipulating that the customer prepays $600 in return for 30 deliveries every month for 6 months.

Assume Direct Delivery receives that $600 payment on December 1 for deliveries to be made between December 1 and May 31.

Direct Delivery has a cash receipt of $600 on December 1, but it does not have revenues of $600 at this point. It will have revenues only when it earns them by delivering the parcels. On December 1, Direct Delivery will show that its asset Cash increased by $600, but it will also have to show that it has a liability of $600. (It has the liability to deliver $600 of parcels within 6 months, or return the money.)

The liability account involved in the $600 received on December 1 is Unearned Revenue.

Unearned revenues - liability account that reports amounts received in advance of providing goods or services (not yet been earned by the company.) When the goods or services are provided, this account balance is decreased and a revenue account is increased.

Each month, as the 30 deliveries are made, Direct Delivery will be earning $100, and as a result, each month $100 moves from the account Unearned Revenue to Service Revenues. Each month Direct Delivery's liability decreases by $100 as it fulfills the agreement by delivering parcels and each month its revenues on the income statement increase by $100.

Another example:

A company required a customer with a poor credit rating to pay $1,300 before beginning any work, the company increases its asset Cash by $1,300 and it should increase its liability Unearned Revenues by $1,300.

As the company does the work, it will reduce the Unearned Revenues account balance and increase its Service Revenues account balance by the amount earned (work performed).

A review of the balance in Unearned Revenues reveals that the company did indeed receive $1,300 from a customer earlier in December. However, during the month the company provided the customer with $800 of services. Therefore, at December 31 the amount of services due to the customer is $500.

Wages Payable - a liability account that reports the amounts owed to employees as of the balance sheet date. Amounts are routinely entered into this account when the company's payroll records are processed. A review of the details confirms that this account's balance of $1,200 is accurate as far as the payrolls that have been processed.

However, under the accrual basis of accounting the balance sheet must report all of the payroll amounts owed by the company—not just the amounts that have been processed.

Similarly, the income statement must report all of the payroll expenses that have been incurred. For example, assume that December 30 is a Sunday and the first day of the payroll period. The wages earned by the employees on December 30-31 will be included in the payroll processing for the week of December 30 through January 5. However, the December income statement and the December 31 balance sheet need to include the wages for December 30-31, but not the wages for January 1-5.

Interest receivable - current asset that represents the amount of interest revenue that was reported as earned, but has not yet been received.

Accrued interest - the amount of loan interest that has already occurred, but has not yet been paid to the lender by the borrower.

The accrued interest will be reported by the borrower as both an expense on its income statement, and a current liability on its balance sheet.

The accrued interest will be reported by the lender as both revenue on its income statement, and a current asset on its balance sheet.

Accrued interest is likely to require adjusting entries by both the borrower and the lender prior to issuing their financial statements.