Adjusting Entries

Adjusting Entries are entries made at the end of year in order to match all expense in current year against the revenues related to these expenses. The adjustment entries will ensure all expenses incurred and revenue generated, which are supposed to be recorded in this year, are not omitted. Without the adjustment entries, there is the likelihood that some of the expenses and revenues of the current period will be recorded in other periods.

Definition of Adjusting Entries

Adjusting Entries referred to the entries which are recorded at the end of period when the financial statements must be prepared, in order to ensure that the revenue recognition and matching principles are followed.

The adjusting entries do not need source of document because they deal with internal events and transactions, in addition they do not involve an exchange transaction with another entity, but it used to ensure that revenues to be recognized in the period which they are earned, and expenses to be recognized in the period in which they are incurred.

Types of adjusting entries

Adjusting entries are necessary for three situations:-

1- Prepayments sometimes referred to as deferrals.

2- Accruals.

3- Estimates.

In this chapter we will focus on the first and second types (Prepayments and

Accruals)

1- Prepayments: Referred to transactions in which the cash flow precedes expenses or revenue recognition.

Prepayments include two types of accounts prepaid expenses and unearned revenue.

a) Prepaid Expenses: Are the costs of assets acquired in one period and expensed in a future period. In asset account is debited (current Assets) to show the service or benefit that will be received in the future, the good examples of the prepaid expenses are prepayments in regard to insurance, supplies, rent.

Example:

On February 1, 2014 Baghdad Company paid ID 24000000 to its landlord representing one year's rent in advance. Assume that the company used:

1- Balance sheet method

2- Income statement method

Required:

1- Record any necessary journal and adjusting entries from 1-1-2014 to December 31, 2014.

2- Show the partial balance sheet on December 31, 2014.

Solution:

24000000 ÷ 12 months = ID 2000000 the rent per month.

One month's rent is paid in advance.

1-Balance sheet method

In 1-2- 2014 the accountant should record the following entry

Prepaid rent expenses	24000000	
Cash		24000000

31-12-2014

Rent expenses	22000000	
Prepaid rent expenses		22000000

2-Income statement method

1-2-2014

Rent expenses	24000000	
Cash		24000000

31- 12- 2014

Prepaid rent expenses	2000000	
Rent Expenses		2000000

Balance Sheet

Current Assets	
Prepaid rent expenses 2000000	

b. Unearned Revenue: It is created when a company receives cash from a customer in one period for goods or services that are to be provided in a future period.

Shortly Unearned Revenue means cash is received in advance: liability is recorded.

Example:

In 1-11-2014 Baghdad Company rented building to Ishtar company for ID 1500 000 per month, in next day Ishtar company paid Baghdad Co. ID 4500 000 in advance.

Required:

1- Record any necessary journal and adjusting entries for a financial period which ended at December 31, 2014.

2- Show the partial balance sheet at December 31, 2014

1_Balance sheet method

2-11-2014

Cash	4500000	
Unearned rent revenue		4500000

31-12-2014

Unearned rent revenue	3000000	
Rent revenue		3000000

2-Income statement method

2-11-2014

Cash	4500000	
Rent revenue		4500000

31-12-2014

Rent Revenue	1500000	
Unearned rent revenue		1500000

Balance Sheet

	Current Liabilities
	Unearned rent revenue 1500000

2. Accruals: They occur when the cash flow comes after either expense or revenue recognition .

For example; a company often uses the services of another company in one financial year and it pays in a subsequent years or periods. The accruals include two types of accounts which are accrued revenue and accrued expenses.

a- Accrued revenue: revenue earned but not received in cash or recorded at the statement date. In other words accrued revenue means the revenue is earned in a period prior to the cash receipt.

Accrued revenue record a debit (increase) to an assets and a credit (increase) to a revenue account .

Example:

On December 31, 2014 Baghdad Company earned ID 1000000 for rent revenue

but did not bill to clients.

Required:

1- Record any necessary adjusting entry for a financial period which ended at December 31, 2014.

2- Show the partial balance sheet on December 31,2014.

Solution:

31-12-2014

Accrued rent revenue	1000000	
Rent revenue		1000000

Balance Sheet

Current Assets	
Accrued rent revenue 1000000	

b- Accrued Expenses: Expenses incurred but not yet paid or recorded at the statement date. In other words expenses have been incurred prior to cash payment.

Accrued expenses record a credit (increase) to a liability account and debit (increase) to an expenses account.

Example: On December 31, 2014 Baghdad's company accountant found that the electricity bill per ID 600000 did not pay.

Required:

1- Record any necessary adjusting entry for a financial period which ended on December 31, 2014.

2- Show the partial balance sheet at December 31, 2014.

Solution:

31-12-2014

Electricity expenses	600000	
Accrued electricity expenses		600000

Balance Sheet

	Current Liabilities
	Accrued electricity expenses 600000

Summary of Prepayments and Accrual

Balance Sheet

Current Assets	Current Liabilities
Accrued revenues	Unearned Revenues
Prepaid Expenses	Accrued Expenses

Example 1: On October 31 , 2008the trial balance for Basrah Co. appeared the following balances .

Trial Balance October 31 , 2008		
Accounts	**Debit**	**Credit**
Cash	15,200	
Supplies	2500	
Prepaid Insurance	600	
Office Equipment	5,000	
Notes Payable		5,000
Accounts Payable		2,700

Unearned Revenue		1,200
capital		10,000
Drawing	500	
Service Revenue		10,000
Salaries Expense	4,000	
Rent Expense	900	
Total	28,700	28,700

We assume that company uses an accounting period of one **monthly**. and thus it makes monthly, adjusting entries.

1. supplies on hand at October 31 total $500.
2. Expired insurance for the month is $ 100.
3. Depreciation for the month is $50.
4. Unearned revenue earned in October totals $600.
5. Services Revenue provided but not recorded at October 31 are $300.
6. Interest accrued at October 31 is $70.
7. Accrued salaries at October 31 are $1,500.

Instructions:

Prepare the adjusting entries at October 31.

($2,500 – $500)

1. Supplies Expense........2,000
   Supplies 2,000
2. Insurance Expense 100
   Prepaid Insurance 100
3. Depreciation Expense.............50
   Accumulated Depreciation 50
4. Unearned Revenue 600
   Service Revenue 600
5. Accrued Service 300
   Service Revenue 300
6. Interest Expense 70
   Interest Payable 70
7. Salaries Expense 1,500
   Accrued Salaries 1,500