FINANCE AT A GLANCE

Adjusting entries

Lesson 54

Right after the generation of the trial balances comes the key step of preparing the *adjusting entries.*

Adjusting entries are accounting entries that are entered into the journal <u>at the end of an accounting period</u> in order to adjust revenues and expenses to the period to which they are ascribable, in accordance with the accrual concept. They are generally based on reality, and not on source documents (sales invoices, purchase invoices, etc.).
The most common adjusting entries are:

Unearned income - These are cash receipts for revenue that is not yet earned, and therefore, are recorded as liabilities.
Accrued liabilities - These are expenses already incurred but not yet paid or recorded, and are recognized as liabilities.
Prepaid expenses - These are cash disbursements for expenses that are not yet incurred, and therefore are recorded as assets.
Accrued assets - These are revenues that are already earned but not yet collected or recorded, and are recognized as assets.
Other common adjusting entries include depreciation, allowance for bad debts and inventory adjustments.

To continue with the accounting cycle that we have been walking through, we shall make adjusting entries for three items mentioned below, for which these definitions will become handy.

1. An increase in an Asset	is called a	*debit*
2. A decrease in an Asset	is called a	*credit*
3. An Expense or a Dividend	is called a	*debit*
4. A reversal of an Expense or a Dividend	is called a	*credit*

5. An increase in a Liability or Equity	is called a	*credit*
6. A decrease in a Liability or Equity	is called a	*debit*
7. A Revenue	is called a	*credit*
8. A reversal of an Revenue	is called a	*debit*

1. The Company estimates that its electricity and telephone bills in January amount to approximately $550. The billings from the electric and telephone companies for January consumption are yet to be received as of January 31, 2010.
   Transaction analysis:
   The estimate of $550 for Utilities in January is an expense, and involves a debit entry. (Please see definition 3.) Since the actual payment takes place past January, an Accrued liability is incurred, and is recorded as a credit entry. (Please see denifinition 5.)
   Adjusting entries:

Dr	Utilities	550	
Cr	Accrued liabilities		550

2. The advertising agency informs the Company that the campaigns in January are worth only $2,000, because of the postponement of what is supposed to have been the last program for the month. The excess $500 is being allocated for the following month's campaign.

   Transaction analysis:

   The Sales and marketing expenses are overbooked by $500. Reducing the already booked Sales and marketing expenses by $500 means a reversal of $500. This is a credit entry. (Please see definition 4 in Lesson 40.)

   The $500 being carried over to the next month's marketing programs is in effect a prepayment of future expenses. This is recognized as in increase in assets called Prepaid expenses. This is a debit entry.
   (Please see definition 1.)

   Adjusting entries:

Dr	Prepaid expenses	550	
Cr	Sales and marketing expenses		550

3. The useful life of the office equipment is estimated to be 5 years or 60 months. We assume that the wear and tear of such equipment in January amounts to 1/60 of its acquisition value, and that is $4,168 (which based on $250,000 divided by 60 months).

   Transaction analysis:

   The wear and tear being ascribable to the month of January is booked as Depreciation, a expense. This is a debit entry. (Please see definition 3.)

   The matching entry is an increase in Accumulated depreciation. Since Accumulated depreciation is a contr asset, an increase I it is a credit entry. (Please see Lesson 53.)

   Adjusting entries:

Dr	Depreciation	4,168	
Cr	Accumulated depreciation		4,168

The next lesson will show the journalization and posting of these entries.