AFA 100: Adjusting Entries

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Definition

Adjusting Entries are made at the **end** of an accounting period to measure earnings properly and correct errors. All adjusting entries affect either an **expense** account or a **revenue** account. There is never cash involved in the adjusting entries.

Importance of Adjusting Entries

According to the matching principle, expenses should be reported in the same period as a related revenue. This is to follow the idea that to earn revenue an expense should be incurred. In a real world example, you would need to purchase inventory to sell it and make a profit.

However, sometimes when there is a difference between when the cash payment is made and when the service is completed, the revenue and expense are not in the same period. This is adjusted for using adjusting entries.

Here's an example:

Let's assume, you are a business owner who supplies advertising services. On November 1, a customer pays $500 in advance for 6 months of advertising services. Also, assume you have a December 31 fiscal year end.

As at December 31, you have only provided 2 out of the 6 months (November and December) of the service. When you haven't performed the service, you have a liability because the customer has given you their cash but you haven't given them the service yet. So, how do you account for the revenue earned on December 31 when you have only supplied 2 months of services?

The adjusting entry on December 31 will show that you have earned 2 months of the money you received. So you are reducing the liability that you owed when you didn't provide any services and increasing the actual revenue earned. As you can see, adjusting entries are meant to properly represent the revenue that you have earned.

Types of Adjusting Entries

Deferred revenue	You have received the cash in advance, but you have earned the revenue by performing the service later
Deferred expense	You have paid the cash now, but you will consume the expense later
Accrued Revenue	You have earned the revenue because you have provided the service/product, but you have not received the payment yet
Accrued Expense	You have consumed an expense, but you will pay for it later

Deferred Revenues (Unearned Revenue)

This is initially recorded as a liability because cash is received before actually doing the work. In other words, you still owe the service you have promised - therefore a liability has been created. The account must be adjusted for the amount of actual revenue earned during the period. At the end of the accounting period, the amount earned is moved from liabilities to revenue.

Let's say John Doe paid you $500 to paint his house on November 1. As at December 31, you have painted 60% of the house. You must record that you have earned this revenue so far.

Initial entry when you receive the payment: (on November 1)

	Dr.	Cr.
Dr. Cash (asset)	500	
Cr. Unearned Revenue (liability)		500

Adjusting Entry at December 31

	Dr.	Cr.
Dr. Unearned Revenue	300 *(500*60%)*	
Cr. Service Revenue		300

This entry reduces the unearned revenue account by the amount that you have used and increases the actual earned revenue account

Deferred Expenses (Prepaid Expenses)

A deferred expense is initially recorded as an asset because you have paid the cash and have yet to receive the service/product. Common accounts you may see are prepaid rent, supplies and equipment. These accounts are adjusted for the amount of expense incurred during the period. Therefore, the prepaid asset account is decreased and the expense account increases. That is, you are taking the money out of the asset account and putting it into an expense account because you have incurred the expense.

Let's say on November 1 you paid $600 of rent in advance for 6 months. On December 31, you will need to adjust the asset called prepaid rent and expense the rent you have used. That is, you move the amount from prepaid rent into actual rent expense that you have incurred.

Initial Entry when you paid the rent advance (November 1)

	Dr.	Cr.
Dr. Prepaid Rent (asset)	600	
Cr. Cash		600

Adjusting Entry at December 31

	Dr.	Cr.
Dr. Rent Expense	200*	
Cr. Prepaid Rent		200

This entry reduces the asset account and increases the expense account

*($600/6 months * 2 months passed *(November & December)*)

Accrued Revenues (Accounts Receivable)

Accrued revenues are revenues that were earned during the period but were not yet recorded because cash will be received in the future. Initially, you have an asset *(accounts receivable)* because you have provided a service/product but you have not received the money yet.

Let's assume that you provided a company with marketing services totalling $1,000. On December 31, you have completed 80% of the services promised and no collection has been received yet.

Adjusting Entry at December 31

	Dr.	Cr.
Dr. Accounts Receivable	800 (1000*80%)	
Cr. Service Revenue		800

This entry records an accounts receivable (asset) and increases revenues.

Once the cash is received

	Dr.	Cr.
Dr. Cash	800	
Cr. Accounts Receivable		800

Accrued Expenses (Accounts Payable)

These are expenses that were incurred during the period but were not yet recorded because cash will be paid in the future.

Let's assume that for the salary earned in the month of December, you pay your employee on January 15. This employee received $20 per day. Because the fiscal year ends earlier than the pay date, you will need to record the payable to be paid on January 15.

Adjusting Entry at December 31

Account	Dr.	Cr.
Dr. Salary Expense	300 ($20 * 15 days)	
Cr. Salary Payable		300

This transaction increases the expense account and increases the liability account (salary payable).

Once the cash payment is made (January 15)

Account	Dr.	Cr.
Dr. Salary Payable	300	
Cr. Cash		300