

1.6: Preparing Various Adjusting Entries

Learning Objectives

At the end of this section, students should be able to meet the following objectives:

1. Explain the need for an adjusting entry in the reporting of prepaid expenses and be able to prepare that adjustment.
2. Explain the need for an adjusting entry in the reporting of accrued revenue and be able to prepare that adjustment.
3. Describe the difficulty of determining when the earning process for revenue is substantially complete and discuss possible resolutions.

*Question: The second adjustment to be considered here involves the handling **prepaid expenses**. In the transactions that were recorded in the previous section, Journal Entry 10 reported a \$4,000 payment made in advance for four months of rent to use a building. An asset—prepaid rent—was recorded through the normal accounting process. This account is listed on the trial balance in Figure 1.19 “Updated Trial Balance”. Why might a year-end adjusting entry be needed in connection with a prepaid expense?*

Answer: During these four months, the Lawndale Company will use the rented facility to help generate revenue. Over that time, the future economic benefit established by the payment gradually becomes a past benefit. The asset literally changes into an expense day by day. For illustrative purposes, assume that one month has now passed since the original payment. This month of benefit provided by the rent (\$1,000 or \$4,000/four months) no longer exists; it has been consumed.

As a preliminary step in preparing financial statements, an adjusting entry is needed to reclassify \$1,000 from the asset into an expense account. This adjustment leaves \$3,000 in the asset (for the remaining three months of rent on the building) while \$1,000 is now reported as an expense (for the previous one month of rent).

Figure 1.20 Adjusting Entry 2: Previously Rented Facility Is Used

Rent Expense	1,000		(increase an expense—debit)
Prepaid Rent		1,000	(decrease an asset—credit)

The basic purpose of adjusting entries is to take whatever amounts reside in the ledger and align them with the requirements of U.S. generally accepted accounting principles (U.S. GAAP). For this illustration, the original \$4,000 payment was classified as a prepaid rent and the adjustment above was created in response to that initial entry.

In recording transactions, some accounting systems mechanically handle events in a different manner than others. Thus, construction of an adjusting entry always depends on the recording that previously took place. To illustrate, assume that when this \$4,000 payment was made, the company’s computer program had been designed to enter a debit to rent expense rather than to prepaid rent. All money spent for rent was automatically recorded as rent expense. This initial accounting has no impact on the final figures to be reported but does alter the adjustment process.

An adjusting entry still needs to be prepared so that the expense appearing on the income statement is \$1,000 (for the past one month) while the asset on the balance sheet is shown as \$3,000 (for the next three months). If the entire cost of \$4,000 is in rent expense, the following alternative is necessary to arrive at the proper balances. It shifts \$3,000 out of the expense and into the asset.

Figure 1.21 Adjusting Entry 3: Alternative Based on a Different Initial Recording

Prepaid Rent	3,000		(increase an asset—debit)
Rent Expense		3,000	(decrease an expense—credit)

This entry leaves \$1,000 in expense and \$3,000 as the asset. Regardless of the account, the accountant first determines the balance that is present in the ledger and then creates the specific adjustment needed to arrive at fairly presented figures.

Check Yourself

Posh Inc. paid an attorney \$10,000 for legal work on a lawsuit against another company on November 1. This represents 50 hours of future services to be received by Posh from the attorney. The \$10,000 is recorded as a prepaid legal cost (asset). At the end of the year (December 31) Posh is notified that 10 hours of legal services have been provided prior to December 31. How much should Posh show as a prepaid legal cost on their balance sheet as of December 31?

- A. \$8,000
- B. \$2,000
- C. \$10,000
- D. \$0

The answer is A. 10 of the 50 hours have been used and become an expense. 10/50 of the legal costs have been used and that is \$2,000 out of the \$10,000. Therefore the adjusting entry would credit the prepaid legal cost for \$2,000 and debit legal expense for \$2,000. This leave the appropriate amount of \$8,000 still in the prepaid legal cost asset representing the other 40 hours of legal work yet to be provided.

Question: Accrued revenue is the third general type of adjustment to be covered here. Based on the title, this revenue is one that grows gradually over time. If not recorded by a company's accounting system, updating is necessary before financial statements are prepared. What adjustment is used to recognize accrued revenue that has not previously been recorded?

Answer: Various types of revenue are earned as time passes rather than through a physical event such as the sale of inventory. To illustrate, assume that a customer comes to the Lawndale Company five days before the end of the year and asks for assistance. The customer must be away for the next thirty days and wants company employees to feed, water, and care for his horses during the period of absence. Everything needed for the job is available at the customer's farm; Lawndale just has to provide the service. The parties agree that the company will receive \$100 per day for this work with payment to be made upon the person's return.

No asset changes hands at the start of this task. Thus, the company's accounting system is not likely to make any entry until payment is eventually received. However, assume that after the first five days of work, the company is ready to prepare financial statements and needs to recognize all revenue earned to date. The service to this customer has been carried out for five days at a rate of \$100 per day. The company has performed the work to earn \$500, an amount that will not be received until later. This receivable and revenue should be recognized through an adjusting entry so that the reported financial figures are fairly presented. The earning process for the \$500 occurred this year and should be recorded in this year.

Figure 1.22 Adjusting Entry 4: Revenue Is Earned for Work Done

Accounts Receivable	500		(increase an asset—debit)
Sales of Services		500	(increase a revenue—credit)

No recognition is needed for cost of goods sold. Inventory is not being sold but rather is a service. The \$500 receivable will be removed in the subsequent period when the customer eventually pays the company for the services rendered.

Question: As discussed earlier, the revenue recognition principle (within accrual accounting) provides formal guidance for the timing of revenue reporting. It states in part that the earning process is governed by a contract and is reviewed using a 5 step process. That seems reasonable. In the above example, the work has only been performed for five days out of a total of thirty. That is not substantially complete. Could revenue be recognized even if only part of the job has been completed?

Answer: This question draws attention to a difficult problem that accountants face frequently in creating a fair portrait of a company. The proper recognition of revenue is one of the most challenging tasks encountered in financial accounting. Here, the simplest way to resolve this issue is to consider the nature of the task to be performed.

According to the contract, is this job a single task to be carried out by the company over thirty days or is it thirty distinct tasks to be handled once a day over this period of time?

If the work of feeding and caring for the horses is one large task like painting a house, then the earning process is only 5/30 finished at the moment and not substantially complete. No revenue is recognized until the work has been performed for twenty-five more days. The previous adjusting entry is not warranted.

Conversely, if this assignment is thirty separate tasks, then five of them are substantially complete and revenue of \$500 is properly recorded by the above entry. Unfortunately, the distinction is not always clear. Because accounting is conservative, revenue should never be recognized unless the contract shows that the individual tasks are clearly separate events.

In Adjusting Entry 3, the assumption is made that the daily tasks are separate and that the company could collect for the work accomplished to date. However, this type of judgment can be extremely difficult in the real world. It is often the product of much thought and discussion. The impact on the financial statements can be material, which increases pressure on the accountant.

Students often enter into a financial accounting course believing that little is required other than learning set rules and then following them mechanically. As will be demonstrated many times in this textbook, nothing ever replaces the need for critical thinking and applying of the accounting rules on the part of the accountant.

Key Takeaway

To align reported balances with the rules of accrual accounting, adjusting entries are created as a step in the preparation of financial statements. Prepaid expenses are normally recorded first as assets and then reclassified to expense as time passes to satisfy the matching principle. The mechanics of this process will vary somewhat based on the initial recording of the payment. Accrued revenues and the corresponding receivables are recognized when the earning process is deemed to be substantially complete. The time at which this benchmark is achieved often depends on whether a single job or a collection of independent tasks is under way. As with so many areas of financial reporting, that decision can rely heavily on professional judgment.

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