

4.2: Discuss the Adjustment Process and Illustrate Common Types of Adjusting Entries

When a company reaches the end of a period, it must update certain accounts that have either been left unattended throughout the period or have not yet been recognized. **Adjusting entries** update accounting records at the end of a period for any transactions that have not yet been recorded. One important accounting principle to remember is that just as the accounting equation (Assets = Liabilities + Owner's equity/or common stock/or capital) must be equal, it must remain equal after you make adjusting entries. Also note that in this equation, owner's equity represents an individual owner (sole proprietorship), common stock represents a corporation's owners' interests, and capital represents a partnership's owners' interests. We discuss the effects of adjusting entries in greater detail throughout this chapter.

There are several steps in the accounting cycle that require the preparation of a trial balance: step 4, preparing an unadjusted trial balance; step 6, preparing an adjusted trial balance; and step 9, preparing a post-closing trial balance. You might question the purpose of more than one trial balance. For example, why can we not go from the unadjusted trial balance straight into preparing financial statements for public consumption? What is the purpose of the adjusted trial balance? Does preparing more than one trial balance mean the company made a mistake earlier in the accounting cycle? To answer these questions, let's first explore the (unadjusted) trial balance, and why some accounts have incorrect balances.

Why Some Accounts Have Incorrect Balances on the Trial Balance

The unadjusted trial balance may have incorrect balances in some accounts.

PRINTING PLUS Unadjusted Trial Balance January 31, 2019		
Account	Debit	Credit
Cash	\$24,800	
Accounts Receivable	1,200	
Supplies	500	
Equipment	3,500	
Accounts Payable		\$ 500
Unearned Revenue		4,000
Common Stock		20,000
Dividends	100	
Service Revenue		<u>9,500</u>
Salaries Expense	3,600	
Utility Expense	<u>300</u>	
Total	<u>\$34,000</u>	<u>\$34,000</u>

Figure 4.2.1: Unadjusted Trial Balance for Printing Plus. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

The trial balance for Printing Plus shows Supplies of \$500, which were purchased on January 30. Since this is a new company, Printing Plus would more than likely use some of their supplies right away, before the end of the month on January 31. Supplies are only an asset when they are unused. If Printing Plus used some of its supplies immediately on January 30, then why is the full \$500 still in the supply account on January 31? How do we fix this incorrect balance?

Similarly, what about Unearned Revenue? On January 9, the company received \$4,000 from a customer for printing services to be performed. The company recorded this as a liability because it received payment without providing the service. To clear this liability, the company must perform the service. Assume that as of January 31 some of the printing services have been provided. Is the full \$4,000 still a liability? Since a portion of the service was provided, a change to unearned revenue should occur. The company needs to correct this balance in the Unearned Revenue account.

Having incorrect balances in Supplies and in Unearned Revenue on the company's January 31 trial balance is not due to any error on the company's part. The company followed all of the correct steps of the accounting cycle up to this point. So why are the balances still incorrect?

Journal entries are recorded when an activity or event occurs that triggers the entry. Usually, the trigger is from an original source. Recall that an original source can be a formal document substantiating a transaction, such as an invoice, purchase order, canceled check, or employee time sheet. Not every transaction produces an original source document that will alert the bookkeeper that it is time to make an entry.

When a company purchases supplies, the original order, receipt of the supplies, and receipt of the invoice from the vendor will all trigger journal entries. This trigger does not occur when using supplies from the supply closet. Similarly, for unearned revenue, when the company receives an advance payment from the customer for services yet provided, the cash received will trigger a journal entry. When the company provides the printing services for the customer, the customer will not send the company a reminder that revenue has now been earned. Situations such as these are why businesses need to make adjusting entries.

Think It Through: Keep Calm and Adjust...

Elliot Simmons owns a small law firm. He does the accounting himself and uses an accrual basis for accounting. At the end of his first month, he reviews his records and realizes there are a few inaccuracies on this unadjusted trial balance.

One difference is the supplies account; the figure on paper does not match the value of the supplies inventory still available. Another difference was interest earned from his bank account. He did not have anything recognizing these earnings.

Why did his unadjusted trial balance have these errors? What can be attributed to the differences in supply figures? What can be attributed to the differences in interest earned?

The Need for Adjusting Entries

Adjusting entries update accounting records at the end of a period for any transactions that have not yet been recorded. These entries are necessary to ensure the income statement and balance sheet present the correct, up-to-date numbers. Adjusting entries are also necessary because the initial trial balance may not contain complete and current data due to several factors:

- The inefficiency of recording every single day-to-day event, such as the use of supplies.
- Some costs are not recorded during the period but must be recognized at the end of the period, such as depreciation, rent, and insurance.
- Some items are forthcoming for which original source documents have not yet been received, such as a utility bill.

There are a few other guidelines that support the need for adjusting entries.

Guidelines Supporting Adjusting Entries

Several guidelines support the need for adjusting entries:

- Revenue recognition principle: Adjusting entries are necessary because the revenue recognition principle requires revenue recognition when earned, thus the need for an update to unearned revenues.
- Expense recognition (matching) principle: This requires matching expenses incurred to generate the revenues earned, which affects accounts such as insurance expense and supplies expense.
- Time period assumption: This requires useful information be presented in shorter time periods such as years, quarters, or months. This means a company must recognize revenues and expenses in the proper period, requiring adjustment to certain accounts to meet these criteria.

The required adjusting entries depend on what types of transactions the company has, but there are some common types of adjusting entries. Before we look at recording and posting the most common types of adjusting entries, we briefly discuss the various types of adjusting entries.

Types of Adjusting Entries

Adjusting entries requires updates to specific account types at the end of the period. Not all accounts require updates, only those not naturally triggered by an original source document. There are two main types of adjusting entries that we explore further, deferrals and accruals.

Deferrals

Deferrals are prepaid expense and revenue accounts that have delayed recognition until they have been used or earned. This recognition may not occur until the end of a period or future periods. When deferred expenses and revenues have yet to be recognized, their information is stored on the balance sheet. As soon as the expense is incurred and the revenue is earned, the information is transferred from the balance sheet to the income statement. Two main types of deferrals are prepaid expenses and unearned revenues.

Prepaid Expenses

Prepaid expenses (prepayments) are assets for which advanced payment has occurred, before the company can benefit from use. As soon as the asset has provided benefit to the company, the value of the asset used is transferred from the balance sheet to the income statement as an expense. Some common examples of prepaid expenses are supplies, depreciation, insurance, and rent.

When a company purchases supplies, it may not use all supplies immediately, but chances are the company has used some of the supplies by the end of the period. It is not worth it to record every time someone uses a pencil or piece of paper during the period, so at the end of the period, this account needs to be updated for the value of what has been used.

Let's say a company paid for supplies with cash in the amount of \$400. At the end of the month, the company took an inventory of supplies used and determined the value of those supplies used during the period to be \$150. The following entry occurs for the initial payment.

JOURNAL			
Date	Account	Debit	Credit
	Supplies Cash <i>To recognize purchase of supplies</i>	400	400

Supplies increases (debit) for \$400, and Cash decreases (credit) for \$400. When the company recognizes the supplies usage, the following adjusting entry occurs.

JOURNAL			
Date	Account	Debit	Credit
	Supplies Expense Supplies <i>To recognize supplies used during the period</i>	150	150

Supplies Expense is an expense account, increasing (debit) for \$150, and Supplies is an asset account, decreasing (credit) for \$150. This means \$150 is transferred from the balance sheet (asset) to the income statement (expense). Notice that not all of the supplies are used. There is still a balance of \$250 ($400 - 150$) in the Supplies account. This amount will carry over to future periods until used. The balances in the Supplies and Supplies Expense accounts show as follows.

Supplies		Salaries Expense	
400	150	150	
Bal. 250		Bal. 150	

Depreciation may also require an adjustment at the end of the period. Recall that *depreciation* is the systematic method to record the allocation of cost over a given period of certain assets. This allocation of cost is recorded over the **useful life** of the asset, or the time period over which an asset cost is allocated. The allocated cost up to that point is recorded in Accumulated Depreciation, a contra asset account. A **contra account** is an account paired with another account type, has an opposite normal balance to the paired account, and reduces the balance in the paired account at the end of a period.

Accumulated Depreciation is contrary to an asset account, such as Equipment. This means that the normal balance for Accumulated Depreciation is on the credit side. It houses all depreciation expensed in current and prior periods. Accumulated Depreciation will reduce the asset account for depreciation incurred up to that point. The difference between the asset's value (cost) and accumulated depreciation is called the **book value** of the asset. When depreciation is recorded in an adjusting entry, Accumulated Depreciation is credited and Depreciation Expense is debited.

For example, let's say a company pays \$2,000 for equipment that is supposed to last four years. The company wants to depreciate the asset over those four years equally. This means the asset will lose \$500 in value each year (\$2,000/four years). In the first year, the company would record the following adjusting entry to show depreciation of the equipment.

JOURNAL			
Date	Account	Debit	Credit
	Depreciation Expense Accumulated Depreciation: Equipment <i>To recognize depreciation for the year</i>	500	500

Depreciation Expense increases (debit) and Accumulated Depreciation, Equipment, increases (credit). If the company wanted to compute the book value, it would take the original cost of the equipment and subtract accumulated depreciation.

$$\text{Book value of equipment} = \$2,000 - \$500 = \$1,500$$

This means that the current book value of the equipment is \$1,500, and depreciation will be subtracted from this figure the next year. The following account balances after adjustment are as follows:

Accumulated Depreciation: Equipment	
	500
	Bal. 500

Depreciation Expense	
	500
	Bal. 500

The book value of an asset is not necessarily the price at which the asset would sell. For example, you might have a building for which you paid \$1,000,000 that currently has been depreciated to a book value of \$800,000. However, today it could sell for more than, less than, or the same as its book value. The same is true about just about any asset you can name, except, perhaps, cash itself.

Insurance policies can require advanced payment of fees for several months at a time, six months, for example. The company does not use all six months of insurance immediately but over the course of the six months. At the end of each month, the company needs to record the amount of insurance expired during that month.

For example, a company pays \$4,500 for an insurance policy covering six months. It is the end of the first month and the company needs to record an adjusting entry to recognize the insurance used during the month. The following entries show the initial payment for the policy and the subsequent adjusting entry for one month of insurance usage.

JOURNAL			
Date	Account	Debit	Credit
	Prepaid Insurance Cash <i>To recognize payment for insurance policy covering six months</i>	4,500	4,500
	Insurance Expense Prepaid Insurance <i>To recognize insurance used during one month</i>	750	750

In the first entry, Cash decreases (credit) and Prepaid Insurance increases (debit) for \$4,500. In the second entry, Prepaid Insurance decreases (credit) and Insurance Expense increases (debit) for one month's insurance usage found by taking the total \$4,500 and dividing by six months ($4,500/6 = 750$). The account balances after adjustment are as follows:

Prepaid Insurance		Insurance Expense	
4,500	750	750	
Bal. 3,750		Bal. 750	

Similar to prepaid insurance, rent also requires advanced payment. Usually, to rent a space, a company will need to pay rent at the beginning of the month. The company may also enter into a lease agreement that requires several months, or years, of rent in advance. Each month that passes, the company needs to record rent used for the month.

Let's say a company pays \$8,000 in advance for four months of rent. After the first month, the company records an adjusting entry for the rent used. The following entries show initial payment for four months of rent and the adjusting entry for one month's usage.

JOURNAL			
Date	Account	Debit	Credit
	Prepaid Rent Cash <i>To recognize payment for rent covering four months</i>	8,000	8,000
	Rent Expense Prepaid Rent <i>To recognize rent used during one month</i>	2,000	2,000

In the first entry, Cash decreases (credit) and Prepaid Rent increases (debit) for \$8,000. In the second entry, Prepaid Rent decreases (credit) and Rent Expense increases (debit) for one month's rent usage found by taking the total \$8,000 and dividing by four months ($8,000/4 = 2,000$). The account balances after adjustment are as follows:

Prepaid Rent		Rent Expense	
8,000	2,000	2,000	
Bal. 6,000		Bal. 2,000	

Another type of deferral requiring adjustment is unearned revenue.

Unearned Revenues

Unearned revenue represents a customer's advanced payment for a product or service that has yet to be provided by the company. Since the company has not yet provided the product or service, it cannot recognize the customer's payment as revenue. At the end of a period, the company will review the account to see if any of the unearned revenue has been earned. If so, this amount will be recorded as revenue in the current period.

For example, let's say the company is a law firm. During the year, it collected retainer fees totaling \$48,000 from clients. Retainer fees are money lawyers collect in advance of starting work on a case. When the company collects this money from its clients, it will debit cash and credit unearned fees. Even though not all of the \$48,000 was probably collected on the same day, we record it as if it was for simplicity's sake.

JOURNAL			
Date	Account	Debit	Credit
	Cash Unearned Fee Revenue <i>To recognize collection of retainer fees</i>	48,000	48,000

In this case, Unearned Fee Revenue increases (credit) and Cash increases (debit) for \$48,000.

At the end of the year after analyzing the unearned fees account, 40% of the unearned fees have been earned. This 40% can now be recorded as revenue. Total revenue recorded is \$19,200 ($\$48,000 \times 40\%$).

JOURNAL			
Date	Account	Debit	Credit
	Unearned Fee Revenue Fee Revenue <i>To recognize fees earned</i>	19,200	19,200

For this entry, Unearned Fee Revenue decreases (debit) and Fee Revenue increases (credit) for \$19,200, which is the 40% earned during the year. The company will have the following balances in the two accounts:

Unearned Fee Revenue		Fee Revenue	
19,200	48,000		19,200
	Bal. 28,800		Bal. 19,200

Besides deferrals, other types of adjusting entries include accruals.

Accruals

Accruals are types of adjusting entries that accumulate during a period, where amounts were previously unrecorded. The two specific types of adjustments are accrued revenues and accrued expenses.

Accrued Revenues

Accrued revenues are revenues earned in a period but have yet to be recorded, and no money has been collected. Some examples include interest, and services completed but a bill has yet to be sent to the customer.

Interest can be earned from bank account holdings, notes receivable, and some accounts receivables (depending on the contract). Interest had been accumulating during the period and needs to be adjusted to reflect interest earned at the end of the period. Note that this interest has not been paid at the end of the period, only earned. This aligns with the revenue recognition principle to recognize revenue when earned, even if cash has yet to be collected.

For example, assume that a company has one outstanding note receivable in the amount of \$100,000. Interest on this note is 5% per year. Three months have passed, and the company needs to record interest earned on this outstanding loan. The calculation for the interest revenue earned is $\$100,000 \times 5\% \times 3/12 = \$1,250$. The following adjusting entry occurs.

JOURNAL			
Date	Account	Debit	Credit
	Interest Receivable Interest Revenue <i>To recognize interest revenue earned and due</i>	1,250	1,250

Interest Receivable increases (debit) for \$1,250 because interest has not yet been paid. Interest Revenue increases (credit) for \$1,250 because interest was earned in the three-month period but had been previously unrecorded.

Interest Receivable	
1,250	
Bal. 1,250	

Interest Revenue	
	1,250
	Bal. 1,250

Previously unrecorded service revenue can arise when a company provides a service but did not yet bill the client for the work. This means the customer has also not yet paid for services. Since there was no bill to trigger a transaction, an adjustment is required to recognize revenue earned at the end of the period.

For example, a company performs landscaping services in the amount of \$1,500. However, they have not yet received payment. At the period end, the company would record the following adjusting entry.

JOURNAL			
Date	Account	Debit	Credit
	Accounts Receivable Service Revenue <i>To recognize service revenue earned and due</i>	1,500	1,500

Accounts Receivable increases (debit) for \$1,500 because the customer has not yet paid for services completed. Service Revenue increases (credit) for \$1,500 because service revenue was earned but had been previously unrecorded.

Service Revenue	
	1,500
	Bal. 1,500

Accounts Receivable	
1,500	
Bal. 1,500	

Accrued Expenses

Accrued expenses are expenses incurred in a period but have yet to be recorded, and no money has been paid. Some examples include interest, tax, and salary expenses.

Interest expense arises from notes payable and other loan agreements. The company has accumulated interest during the period but has not recorded or paid the amount. This creates a liability that the company must pay at a future date.

For example, a company accrued \$300 of interest during the period. The following entry occurs at the end of the period.

JOURNAL			
Date	Account	Debit	Credit
	Interest Expense Interest Payable <i>To recognize interest expense incurred but not paid</i>	300	300

Interest Expense increases (debit) and Interest Payable increases (credit) for \$300. The following are the updated ledger balances after posting the adjusting entry.

Interest Payable	
	300
	Bal. 300

Interest Expense	
300	
Bal. 300	

Taxes are only paid at certain times during the year, not necessarily every month. Taxes the company owes during a period that are unpaid require adjustment at the end of a period. This creates a liability for the company. Some tax expense examples are income and sales taxes.

For example, a company has accrued income taxes for the month for \$9,000. The company would record the following adjusting entry.

JOURNAL			
Date	Account	Debit	Credit
	Income Tax Expense Income Tax Payable <i>To recognize income tax expense incurred but not paid</i>	9,000	9,000

Income Tax Expense increases (debit) and Income Tax Payable increases (credit) for \$9,000. The following are the updated ledger balances after posting the adjusting entry.

Income Tax Payable	
	9,000
	Bal. 9,000

Income Tax Expense	
9,000	
Bal. 9,000	

Many salaried employees are paid once a month. The salary that the employee earned during the month might not be paid until the following month. For example, the employee is paid for the prior month's work on the first of the next month. The financial statements must remain up to date, so an adjusting entry is needed during the month to show salaries previously unrecorded and unpaid at the end of the month.

Let's say a company has five salaried employees, each earning \$2,500 per month. In our example, assume that they do not get paid for this work until the first of the next month. The following is the adjusting journal entry for salaries.

JOURNAL			
Date	Account	Debit	Credit
	Salaries Expense Salaries Payable <i>To recognize salaries expense incurred but not paid</i>	12,500	12,500

Salaries Expense increases (debit) and Salaries Payable increases (credit) for \$12,500 (\$2,500 per employee × five employees). The following are the updated ledger balances after posting the adjusting entry.

Salaries Payable	
	12,500
	Bal. 12,500

Salaries Expense	
12,500	
Bal. 12,500	

Your Turn: Adjusting Entries

Example	Income Statement Account	Balance Sheet Account	Cash in Entry?

Table 4.2.1

Review the three adjusting entries that follow. Using the table provided, for each entry write down the income statement account and balance sheet account used in the adjusting entry in the appropriate column. Then in the last column answer yes or no.

	Supplies Expense Supplies	500	500
	Unearned Revenue Service Revenue	2,000	2,000
	Rent Expense Prepaid Machine Rent	1,200	1,200

Answer

Example	Income Statement Account	Balance Sheet Account	Cash in Entry?
1	Supplies expense	Supplies	no
2	Service Revenue	Unearned Revenue	no
3	Rent Expense	Prepaid machine rent	no

Table 4.2.2

Your Turn: Adjusting Entries Take Two

Did we continue to follow the rules of adjusting entries in these two examples? Explain.

	Electricity Expense Accounts Payable	100	100
	Salaries Expense Salaries Payable	4,000	4,000

Example	Income Statement Account	Balance Sheet Account	Cash in Entry?

Table 4.2.3

Answer

Yes, we did. Each entry has one income statement account and one balance sheet account, and cash does not appear in either of the adjusting entries.

Example	Income Statement Account	Balance Sheet Account	Cash in Entry?
1	Electricity Expense	Accounts Payable	no
2	Salaries Expense	Salaries Payable	no

Table 4.2.4

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