

Adjusting Entries

Adjusting entries are journal entries made at the end of the accounting period to allocate revenue and expenses to the period in which they actually are applicable. Adjusting entries are required because normal journal entries are based on actual transactions, and the date on which these transactions occur may not be the date required to fulfill the matching principle of accrual accounting.

The two major types of adjusting entries are:

- **Accruals:** for revenues and expenses that are matched to dates *before* the transaction has been recorded.
- **Deferrals:** for revenues and expenses that are matched to dates *after* the transaction has been recorded.

Accruals

Accrued items are those for which the firm has been realizing revenue or expense without yet observing an actual transaction that would result in a journal entry. For example, consider the case of salaried employees who are paid on the first of the month for the salary they earned over the previous month. Each day of the month, the firm accrues an additional liability in the form of salaries to be paid on the first day of the next month, but the transaction does not actually occur until the paychecks are issued on the first of the month. In order to report the expense in the period in which it was incurred, an adjusting entry is made at the end of the month. For example, in the case of a small company accruing \$80,000 in monthly salaries, the journal entry might look like the following:

Date	Account Titles & Explanation	Debit	Credit
9/30	Salary expense	80,000	
	Salaries payable		80,000
	<i>Salaries accrued in September, to be paid on Oct 1.</i>		

In theory, the accrued salary could be recorded each day, but daily updates of such accruals on a large scale would be costly and would serve little purpose - the adjustment only is needed at the end of the period for which the financial statements are being prepared.

Some accrued items for which adjusting entries may be made include:

- Salaries
- Past-due expenses
- Income tax expense
- Interest income
- Unbilled revenue

Deferrals

Deferred items are those for which the firm has recorded the transaction as a journal entry, but has not yet realized the revenue or expense associated with that journal entry. In other words, the recognition of deferred items is postponed until a later accounting period. An example of a deferred item would be prepaid insurance. Suppose the firm prepays a 12-month insurance policy on Sep 1. Because the insurance is a prepaid expense, the journal entry on Sep 1 would look like the following:

Date	Account Titles & Explanation	Debit	Credit
9/1	Prepaid Expenses	12,000	
	Cash		12,000
	<i>12-month prepaid insurance policy.</i>		

The result of this entry is that the insurance policy becomes an asset in the Prepaid Expenses account. At the end of September, this asset will be adjusted to reflect the amount "consumed" during the month. The adjusting entry would be:

Date	Account Titles & Explanation	Debit	Credit
9/30	Insurance Expense	1,000	
	Prepaid Expenses		1,000
	<i>Insurance expense for Sep.</i>		

This adjusting entry transfers \$1000 from the Prepaid Expenses asset account to the Insurance Expense account to properly record the insurance expense for the month of September. In this example, a similar adjusting entry would be made for each subsequent month until the insurance policy expires 11 months later.

Some deferred items for which adjusting entries would be made include:

- Prepaid insurance
- Prepaid rent
- Office supplies
- Depreciation
- Unearned revenue

In the case of unearned revenue, a liability account is credited when the cash is received. An adjusting entry is made once the service has been rendered or the product has been shipped, thus realizing the revenue.

Completing the Adjusting Entries

To prevent inadvertent omission of some adjusting entries, it is helpful to review the ones from the previous accounting period since such transactions often recur. It also helps to talk to various people in the company who might know about unbilled revenue or other items that might require adjustment

