

# Adjusting Entries

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The revenue recognition principle states that revenues are recorded when earned. The matching principle states that expenses are matched to the accounting period, when the revenue they helped produce, was earned.

Expenses are recorded when they are incurred or used up. We also refer to this as when they expire. Expenses are recorded when they expire.

An easy way to remember this: Match revenues and expenses to the proper accounting period. Record revenues when earned and expenses when incurred (used up or expired).

Why do we need to make adjusting entries? We need to match revenues and expenses to the proper period. This action results in an objective net income because the revenues earned are matched with the expenses incurred to earn that revenue. This is the basis for accrual accounting, which is required by GAAP -- Generally Accepted Accounting Principles.

The result: The determination of an objective net income as well as the correct balances on the Balance Sheet.

The problem: At the end of the accounting period (one month, one quarter, six months, or one year – management decides), some revenues and expenses are not properly recorded.

The solution: The adjusting process (adjusting entries – AEs) is necessary to make sure that all revenues and expenses are properly recorded.

When working with AEs, remember two very important rules. First, cash is not involved. Cash is recorded when it is received or paid. It is adjusted when the monthly bank reconciliation is made. Cash is not part of the end of accounting period adjusting process. Second, adjusting entries will involve either a revenue or expense.

There are two categories of adjusting entries – Deferrals and Accruals. Deferrals – The accounting records reflect an account balance. On the last day of the accounting period, an adjustment is needed to bring that account balance to its correct amount. In doing so, either a revenue or expense is also recorded.

Can we have some examples? Absolutely

Deferral Example: Prepaid Expenses – assets that represent amounts paid in advance. They include insurance, supplies, advertising, and rent. The company pays for these before using them to generate revenue.

Deferral Example: Plant Assets (Property, Plant, and Equipment -- PPE) – When an asset that will be used in business operations for more than one year is acquired, the cost is debited to the asset account, for

example Computer. Depreciation is then computed. Depreciation represents the allocation of the cost of the plant asset. You will cover the computation in more detail in a later chapter.

Other examples of plant assets include buildings, equipment, autos and furniture.

Deferral Example: Unearned Revenue is a liability account. This represents the receipt of cash before the revenue has been earned. The company receives payment for goods or services before it has earned the revenue. A liability exists because the company either must deliver the goods or provide the services or it must refund the payment.

Now let's look at accruals – On the last day of the accounting period, revenues have been earned and/or expenses have been incurred. However, nothing has been recorded on the books. The adjusting entries are needed to record these events.

Let's look at more examples. I'm glad they help.

Accrual Example: Service Revenue – On the last day of the accounting period, there may be amounts that have been earned (goods have been delivered or services have been performed) but the billing (Accounts Receivable) has not yet been made. To comply with the revenue recognition principle, the revenue must now be recorded. The asset, Accounts Receivable and Fees Receivable, must also be recorded.

Similar adjustments are needed for interest revenue (interest has been earned on a note receivable but the cash is not yet due) as well as dividend revenue (dividends have been earned on stock investments but the cash has not yet been received).

Accrual Example: Salary Expense –If the accounting period ends during a payroll period, an adjustment is needed for accrued salary expense. This adjustment ensures that all expenses are properly recorded during the accounting period (compliance with the matching principle). Cash will be paid on payday (which occurs after the end of the accounting period).

Similar adjustments are needed for accruals of interest expense (interest has accrued on a note payable but the cash is not yet due), rent expense, utilities expense, and other expenses that have been incurred (used up) on the last day of the accounting period but have not yet been paid. The debit is to an expense and the credit is to a liability account.

Think of adjusting entries as the way to ensure that all revenues and expenses have been recorded in the proper accounting period.

Accountants must analyze account balances and events to determine which adjustments are needed. After the adjusting entries have been posted the ledger accounts, financial statements can be prepared.

The next module discusses 7 examples of adjusting entries.