6 types of adjusting entries

Adjusting entries are often necessary at the end of an accounting period to make adjustments to the balances in the company's general ledger accounts. These entries, called AJEs (adjusting journal entries), are first recorded in the adjusting journal and they bring accounts such as depreciation, amortization, inventory, liabilities, loan balances and accruals up to date so the financial statements accurately reflect the company's financial condition. AJEs can also be be used to correct errors in posting original transactions. Each AJE involves at least one debit entry and at least one credit entry, along with a written explanation of the purpose of the AJE. Record depreciation expense and amortization expense for the period. Depreciation schedules track the used portion of fixed assets' useful lives, such as property, plant and equipment. Amortization schedules track the used portion of intangible assets' useful lives, such as start-up costs, patents, loan points and copyrights. Make these AJEs by posting a debit to the depreciation or amortization expense accounts and a credit to the accumulated depreciation account or the accumulated amortization account. Write an explanation below each of these transactions in the adjusting journal, such as, "To record depreciation (or amortization) expense for the year ending 12/31/20XX." Adjust inventory accounts by crediting the amount used in production during the period to the inventory account and debiting an equal amount to the cost of goods sold account. Write an explanation under the entry in the adjusting journal, such as, "To record inventory used for the year ending 12/31/20XX." There may be many inventory accounts if each item is tracked separately, and this requires an entry to each of the inventory accounts. Just be sure that the total credits to these accounts is equal to the total debits to cost of goods sold. Bring loan balances up to date by making AJEs to the short term and long term loans payable and loans receivable accounts. Short term loan balances are the amounts payable or receivable within one year. Long term balances are those amounts payable or receivable over periods longer than one year. These balances are usually adjusted at the end of the year so the amounts due during the subsequent year are segregated from the remainder of the loans. Debit the long term loan amounts for the amounts equal to the next fiscal year's payments, and credit these amounts to short term loan accounts. Write an explanation such as, "To adjust short term/long term loan balances (payable or receivable) for the year ending 12/31/20XX." Accrue amounts owed and receivable at the end of a period that will be paid or received during the next period by recording them with adjusting journal entries. For example, if employees have earned wages during one period, but will not be paid until the subsequent period, record payroll liabilities by crediting wages payable and debiting wage expense. Sales made during the current period which customers will pay for during the next period require a debit to accounts receivable and a credit to sales. Expenses incurred during the current period which the company will pay during the next period require a credit to accrued expenses and a debit to an appropriate expense account. Write an explanation such as, "To accrue wages earned at 12/31/20XX, payable on 1/31/20XX." Correct errors in posting with AJEs to provide transparency in the accounting for the period. It's possible with some accounting software to simply go back to the original entry and correct the error there, but using AJEs for these corrections acknowledges that an honest error was made, recognized and corrected. Changing original entries after they are made may raise the suspicion that someone is trying to cover up mistakes or even illegal activity. Tips Make adjusting journal entries at the end of any period financial statements will be prepared. These may be monthly or quarterly financial statements (interim financial statements) or annual financial statements. Explanations for interim financial statements include the period for which the adjustments are made, such as " . . . for the month ending January 31, 20XX," or " . . . for the quarter ending March 31, 20XX." The explanation should be clear enough so you have no trouble remembering why the entries were made when looking at them later. Warnings As these adjusting entries are made to the adjusting journal, remember to also post them to the appropriate general ledger accounts. Most accounting software, such as QuickBooks, make these postings to the general ledger automatically when you enter them in the adjusting journal. A perpetual inventory system tracks inventory continuously. It adds up all the purchases in the "inventory" or "merchandise inventory" account, and moves them to the "cost of goods sold" account as they are sold. However, a periodic inventory system provides a balance of the inventory account only at the end of an accounting period. At year end, the inventory balance is adjusted to reflect the physical count through two entries: first, remove the beginning inventory to a temporary "income summary" account and second, enter the physical inventory balance. Remove the beginning merchandise inventory balance. In a periodic inventory system, this balance is kept steady until an actual physical count that, due to the costs involved, usually only happens at fiscal year-end. Debit or increase the income summary account and credit or remove the merchandise inventory account. In other words, move the inventory balance to the income summary account. Enter the ending merchandise inventory balance, which is the physical count. Credit or decrease income summary and debit or increase merchandise inventory. Calculate the cost of goods sold. In a periodic system, purchases of new merchandise inventory and sales are tracked in the "purchases" and "sales" accounts respectively. Add purchases to the beginning inventory, which is the prior period's ending inventory, to get the goods available from sale. Subtract the ending merchandise inventory to get the cost of goods sold. For example, if the beginning merchandise inventory balance is $1,000 and purchases during the period are $500, then goods available for sale equals $1,500 ($1,000 + $500). If the ending merchandise inventory is $900, then the cost of goods sold is $600 ($1,500 - $900). Understanding accrual accounting requires understanding adjusting entries. The purpose of these entries is to properly adjust the accounting statements for accrual-basis accounting. Adjusting entries typically have an impact on the income statement and balance sheet. The cash flow statement is typically not affected. The American accounting system is based on the generally accepted accounting principles (GAAP). The GAAP system is an accrual-based system, which means that revenues are recognized when they are earned and expenses are recognized when they are incurred. This creates a gap between cash and accrual accounting. Because a cash transaction does not have to occur for revenue or expenses to be recognized, this creates the need for adjusting entries. Adjusting entries are made at the end of the accounting period to allocate revenues and expenditures to the right time periods. They are used very often, as companies often have expenses and revenues that do not match up with the cash inflows and outlays. Examples of accounts that often need adjusting entries are prepaid assets and unearned revenue. However, other accounts also need to be adjusted on a regular basis. Fixed assets that are subject to depreciation are subject to adjusting entries even though no cash transactions occur. On Jan. 1, a company pays rent for the whole year of $12,000, or $1,000 a month. The only transaction on the books at the point is the cash outflow of $12,000 and the prepaid rent asset of $12,000, but there is nothing on the income statement. At the end of January, the company has to recognize $1,000 of rent expense on its income statement and lower prepaid rent asset by $1,000. No cash expense or transaction occurs. On Jan. 1, a company receives $1 million in cash for products and services to be delivered in February. On Jan. 1, that is booked as $1 million in unearned revenue and no revenue is recognized on the income statement. A cash flow of $1 million occurs also. At the end of February, after the obligation is satisfied, the company has to recognize $1 million to revenue on its income statement and decrease $1 million of unearned revenue. Revenue is recognized without there being a cash outflow. In accrual basis accounting, adjusting journal entries are necessary because the exchange of cash does not always occur at the moment you purchase an item, provide services or incur an expense. Adjusting journal entries are completed at the end of an accounting period, and help to give a more accurate picture of a company's financial status. These entries include accrued liabilities and assets, and deferred expenses and revenues. Accrued revenues include items or services that you have delivered or performed but for which you have not yet received payment. When you bill your customer for the work you have completed, you start the process to recognize revenues that you have earned. You will recognize this revenue by recording the adjusting entry for accrued revenues, debiting the receivable account and crediting the revenue account. When you do receive a payment, you would then adjust your journal by debiting cash and crediting the applicable receivable account. Unearned revenue, or deferred revenue, is the cash you receive for services you have not yet performed, or items you have not yet delivered. Unearned revenue is recognized as a liability until you deliver the item or perform the service. For example, when your customer gives you a deposit for services you will perform over the next year, you would debit cash and credit your unearned revenue account. Each month as you earn the monthly portion of the deposit, you would then prepare an adjusting journal entry by debiting the unearned revenue account and crediting the revenue account. Accrued expenses or accrued liabilities are expenses that you incur but for which you have not issued payment. Accrued expenses include rent you owe for your office, interest on your business loans and your employees' earnings that you have not yet paid. To recognize an accrued expense, prepare an adjusting journal entry by debiting the applicable expense account and crediting the matching payable account. When you issue payments, reverse the entry by debiting cash and crediting the expense payable account. Also called deferred expenses, prepaid expenses include any expense that you pay but incur on a future date. Your insurance premium is an example of a prepaid expense. You pay the annual cost of your policy, but each month you would recognize the monthly portion of your payment. When you prepay an expense, you debit the applicable expense account and credit cash. When you prepare your monthly adjusting entries in your journal, you would then debit the applicable expense account and credit the prepaid expenses account. 6 types of adjusting entries in accounting

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