



## Adjusting the Accounts

Anytime we prepare financial statements or reach the end of an accounting period, there are account adjustments that need to be made to ensure that revenues are recorded in the time period in which they were earned and expenses are recognized in the period in which they were incurred, following the accrual basis of accounting.

The three reasons adjusting entries have to be made are: a) some events are not recorded daily because it is time consuming and inefficient to do so, b) some costs are not recorded on a daily basis because they expire with the passage of time, rather than being a specific transaction on a single day, and c) some items may simply not be recorded yet. Adjusting entries can be classified as either dealing with prepayments and accruals.

**Prepayments** are paid in advance of the service being provided (**unearned revenue**) or of the service being used/consumed (**prepaid expenses**). Adjusting entries for unearned revenue will be about adjusting for a partially or fully completed amount of a prepaid service during the accounting period. Adjusting entries for prepaid expenses will be about recognizing that a prepaid asset (e.g. prepaid insurance) has been used over time and the expense of the used amount of the asset must be recognized.

**Accruals** are **revenues** or **expenses** that have built up in time (accumulated) but have not been recorded or paid in cash yet. These are usually for transactions that are too inconvenient to record on a daily basis. For example, if a business has an interest-earning investment, it will not recognize the accrued revenue from that investment until the end of an accounting period. It would be a waste of time and energy to enter the interest earned every day as a single transaction.

You can memorize the following table that summarizes the entries needed for each type of adjustment, but it will be better in the long run to understand the reasoning behind each, rather than just remembering which accounts should be debited or credited.

Type of Adjustment	Reason for Adjustment	Adjusting Entries
Prepaid Expenses	Prepaid expenses originally recorded as assets have been partially or completely used	Dr. Expenses Cr. Assets
Unearned Revenues	Unearned revenues already recorded as a liability have now been partially or fully earned	Dr. Liabilities Cr. Revenues
Accrued Revenues	Revenues have been earned but not yet recorded or cash received	Dr. Assets Cr. Revenues
Accrued Expenses	Expenses have been incurred but not yet recorded or paid in cash	Dr. Expenses Cr. Liabilities



*Example 1:* A company has prepaid \$1200 for a year's worth of insurance at the beginning of the year. At the end of June, the company wants to prepare its financial statements. What adjustments must be made?

*Solution:* This question has to do with prepaid expenses. The prepaid insurance account value of \$1200 is overstated in value at the end of the 6 months. This asset account must be credited to reduce its value. The business has used 6 months worth of insurance from January to June and must recognize that as an expense.

<i>June 30</i>	<i>Insurance expense</i>	\$600	( $\$1200 \times 6/12$ )
	<i>Prepaid insurance</i>		600

*Example 2:* Thalia Productions completed \$3,750 worth of filming services on August 14 for Amina Rupert who had prepaid \$5,000 to the company. What adjustments must be made?

*Solution:* This question has to do with unearned revenue. Now that part of the service has been completed, the value of the liability is overstated and the value of revenue is understated. The revenue earned must be recognized.

<i>September 30</i>	<i>Unearned Revenue</i>	\$3,750	
	<i>Service Revenue</i>		3,750

*Example 3:* On February 28, Mejong Restaurant owed employees \$400 in salaries to be paid on March 1. To prepare the monthly financial statements for February, what adjusting entries need to be made?

*Solution:* This question has to do with accrued expenses. The restaurant needs to recognize salaries expense of \$400 even though it hasn't paid it or recorded it yet. Otherwise it is understating the amount of expenses for the month. It also needs to recognize a liability of salaries payable or it will be understating its amount of liabilities.

<i>February 28</i>	<i>Salaries expense</i>	\$400	
	<i>Salaries payable</i>		400

Once the adjustments are made in the general journal, they are posted to the ledger, and then an adjusted trial balance can be prepared.

## Practice Exercises

- Write the adjusting entries for the following information:
  - Inventory on February 1 was \$1,050. At the end of February, inventory on hand is \$400.
  - Depreciation on kitchen equipment is estimated to be \$2,400 for the year. Adjust for depreciation during the first quarter of the year.
  - Unearned revenue at the beginning of March is \$4,500. One-half of the unearned revenue was earned in March.



- d. A \$12,000 six-month note payable requiring an annual interest rate of 8% was signed on January 1. Adjust for interest as of January 31.
  - e. In March, the company earned \$300 for services that were not billed to clients before March 31.
2. Sammy Wilson and friends started a consulting firm, *Wilson Consultants Inc.*, on January 01, 2010. The company helps organizations improve their performance by analyzing existing business problems and developing plans for improvements. This is how the trial balance looks on January 31, 2010.

**Wilson Consultants Inc.  
Trial Balance  
January 31, 2010**

Account No.	Account	Debit	Credit
100	Cash	7,750	
110	Accounts Receivable	6,000	
120	Prepaid Insurance	2,400	
130	Supplies	2,000	
135	Office Equipment	15,000	
200	Accounts payable		4,500
230	Unearned Service Revenue		4,000
311	Common Stock		21,750
400	Service Revenue		7,900
510	Salaries Expense	4,000	
520	Rent Expense	1,000	

In addition to these accounts listed on the trial balance, the chart of accounts for Wilson Consultants Inc. also contains the following accounts and account numbers: No. 136 Accumulated Depreciation-Office Equipment; No. 210 Utilities Payable; No. 220 Salaries Payable; No. 530 Depreciation Expense; No. 540 Insurance Expense; No. 550 Utilities Expense; and No 560 Supplies Expense.

*Additional Information:*

- i. Supplies on hand on January 31 are \$1,300.
- ii. A utility bill for \$150 has not been recorded and will not be paid until next month.
- iii. The insurance policy is for a year.
- iv. \$2,500 of unearned service revenue has been earned at the end of the month.
- v. Salaries of \$1,500 are accrued on January 31, 2010.
- vi. The office equipment has a 5-year life and a residual value of \$3,000. Use straight-line depreciation method.
- vii. Invoices representing \$3,000 of services performed during the month have not been recorded as of January 31, 2010.

*Instructions:*

- a. Prepare adjusting entries. Use "J1" as the page number for your journal.
- b. Post the adjusting entries to the ledger accounts.
- c. Prepare an adjusted trial balance on January 31, 2010.



## Solutions

1. a. Inventory Expense      \$650              (\$1,050 – 400 = \$650)  
       Inventory                      \$650
- b. Depreciation Expense    \$600              (\$2,400 ×  $\frac{4}{12}$ )  
       Acc- Depreciation            \$600
- c. Unearned Revenue        \$2,250  
       Service Revenue            \$2,250
- d. Interest Expense         \$80                (\$12,000 × 0.08 ×  $\frac{1}{12}$ )  
       Interest Payable             \$80
- e. Accounts Receivable      \$300  
       Service Revenue            \$300

2. a.

Date	Account Title & Explanation	Ref.	Debit	Credit
Jan 31	Supplies Expense	560	700	
	Supplies	130		700
Jan 31	Utilities Expense	550	150	
	Utilities Payable	210		150
Jan 31	Insurance Expense ( $\$2,400 \div 12 \text{ months}$ )	540	200	
	Prepaid Insurance	120		200
Jan 31	Unearned Service Revenue	230	2,500	
	Service Revenue	400		2,500
Jan 31	Salaries Expense	510	1,500	
	Salaries Payable	220		1,500
Jan 31	Depreciation Expense	530	200	
	Accumulated Depreciation- Office Equipment	136		200
Jan 31	Accounts Receivable	110	3,000	
	Service Revenue	400		3,000

b.

Account Title: Cash		No. 100			
Date	Explanation	Ref.	Debit	Credit	Balance
Jan 31	Balance	✓			7,750
Account Title: Accounts Receivable		No. 110			
Date	Explanation	Ref.	Debit	Credit	Balance
Jan 31	Balance	✓			6,000
Jan 31	Adjusting	J1	3,000		9,000
Account Title: Prepaid Insurance		No. 120			
Date	Explanation	Ref.	Debit	Credit	Balance
Jan 31	Balance	✓			2,400
Jan 31	Adjusting	J1		200	2,200
Account Title: Supplies		No. 130			
Date	Explanation	Ref.	Debit	Credit	Balance
Jan 31	Balance	✓			2,000
Jan 31	Adjusting	J1		700	1,300



Account Title: Office Equipment				No. 135	
Date	Explanation	Ref.	Debit	Credit	Balance
Jan 31	Balance	✓			15,000
Account Title: Accumulated Depreciation- Office Equipment				No. 136	
Date	Explanation	Ref.	Debit	Credit	Balance
Jan 31	Adjusting	J1		200	200
Account Title: Accounts Payable				No. 200	
Date	Explanation	Ref.	Debit	Credit	Balance
Jan 31	Balance	✓			4,500
Account Title: Utilities Payable				No. 210	
Date	Explanation	Ref.	Debit	Credit	Balance
Jan 31	Adjusting	J1		150	150
Account Title: Salaries Payable				No. 220	
Date	Explanation	Ref.	Debit	Credit	Balance
Jan 31	Adjusting	J1		1,500	1,500
Account Title: Unearned Service Revenue				No. 230	
Date	Explanation	Ref.	Debit	Credit	Balance
Jan 31	Balance	✓			4,000
Jan 31	Adjusting	J1	2,500		1,500
Account Title: Common Stock				No. 311	
Date	Explanation	Ref.	Debit	Credit	Balance
Jan 31	Balance	✓			21,750
Account Title: Service Revenue				No. 400	
Date	Explanation	Ref.	Debit	Credit	Balance
Jan 31	Balance	✓			7,900
Jan 31	Adjusting	J1		2,500	10,400
Jan 31	Adjusting	J1		3,000	13,400
Account Title: Salaries Expense				No. 510	
Date	Explanation	Ref.	Debit	Credit	Balance
Jan 31	Balance	✓			4,000
Jan 31	Adjusting	J1	1,500		5,500
Account Title: Rent Expense				No. 520	
Date	Explanation	Ref.	Debit	Credit	Balance
Jan 31	Balance	✓			1,000
Account Title: Depreciation Expense				No. 530	
Date	Explanation	Ref.	Debit	Credit	Balance
Jan 31	Adjusting	J1	200		200
Account Title: Insurance Expense				No. 540	
Date	Explanation	Ref.	Debit	Credit	Balance
Jan 31	Adjusting	J1	200		200



Account Title: Utilities Expense				No. 550	
Date	Explanation	Ref.	Debit	Credit	Balance
Jan 31	Adjusting	J1	150		150

  

Account Title: Supplies Expense				No. 560	
Date	Explanation	Ref.	Debit	Credit	Balance
Jan 31	Adjusting	J1	700		700

c.

**Wilson Consultants Inc.  
Adjusted Trial Balance  
January 31, 2010**

Account No.	Account	Debit	Credit
100	Cash	\$ 7,750	
110	Accounts Receivable	9,000	
120	Prepaid Insurance	2,200	
130	Supplies	1,300	
135	Office Equipment	15,000	
136	Accumulated Depreciation- Office Equipment		\$ 200
200	Accounts payable		4,500
210	Utilities payable		150
220	Salaries payable		1,500
230	Unearned Service Revenue		1,500
311	Common Stock		21,750
400	Service Revenue		13,400
510	Salaries Expense	5,500	
520	Rent Expense	1,000	
530	Depreciation Expense	200	
540	Insurance Expense	200	
550	Utilities Expense	150	
560	Supplies Expense	700	
	<b>Total</b>	<b>\$43,000</b>	<b>\$43,000</b>

**Reference:** Weygandt, J. et al. Hospitality Financial Accounting. Second Edition. John Wiley and Sons, Inc, New Jersey. 2009



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