ADJUSTMENT ENTRIES (I)

- In order to ascertain the fair and true results of a business for a particular period, it is essential that all the expenses, revenues related only to that period or year should be considered
- If Financial Statement for 2016 are prepared, then the expenses and revenues related to 2015 and 2017 should not be considered, the focus will be on 2016 incurred expenses and earned revenues
- Adjusting entries are needed to ensure that the revenue recognition and expense recognition principles are followed.
- The trial balance may not contain up-to-date and complete data for several reasons:
  - Some events are not recorded daily because it is not efficient to do so
  - Some costs are not recorded during the accounting period because these costs expire with the passage of time rather than as a result of recurring daily transactions
  - Some items may be unrecorded
- Adjusting entries are required every time a company prepares financial statements
- Every adjusting entry will include one income statement account and one balance sheet account
- Cash is not adjusted at the end of the accounting period, thus should not use cash in the adjusting process
- Adjustments are made to assign amounts of revenue or expense to the proper accounting period before finalizing the books for the fiscal period
- The records of such transactions in the book of prime entry are called adjustments. An adjustment means to make a correct record of a transaction which has not been entered or which has been entered but in an incomplete or wrong manner
- Adjusting entries can be classified as deferrals, accruals and others. Each of these classes has subcategories.

16.1 Deferrals

- To defer means to postpone or delay
- Deferrals are costs or revenues that are recognized at a date later than the point when cash was originally exchanged
- Companies make adjusting entries for deferrals to record the portion of the deferred item that was incurred as an expense or earned as revenue during the current accounting period. The two types of deferrals are prepaid expenses and unearned revenues

16.1.1 Prepaid Expenses

- Expenses paid in cash and recorded as assets until they are used or consumed. Prepaid expenses are costs that expire with the passage of time (i. e. rent and insurance) or through use (i. e. supplies)
- Expenses are paid in advance are called prepaid expenses or unexpired expenses
- Cost always has two parts one is expired and other on is unexpired. It is not unlikely that some expenses may have been paid in advance
- Companies record payments of expenses that will benefit more than one accounting
- Examples of common prepayments are insurance, supplies, advertising, and rent. In addition, companies make prepayments when they purchase buildings and equipment
  - Prepaid expenses are costs that expire either with the passage of time (e.g., rent and insurance) or through use (e.g., supplies). The expiration of these costs does not require daily entries, which would be impractical and unnecessary

Example # 16.1: For example, on September 1, 2015 full year insurance paid of Rs. 24,000. We will utilize this expense for 12 months and we have 4 months expense for 2015 and remaining for 2016. Prepaid expenses has two case on the basis of journal entry and trial balance presentation

Case 1: *Expense Method*

General Journal

Date		Account Titles and Explanation	Ref	Amount (Rs) Debit	Credit
2015					
September	1	Insurance Expense		24,000	
		Cash			24,000
		(Insurance expense recorded)			

The effect of above regular entry in end of year trial balance is presented below

Trial Balance

S. No.	*Heads of Account*	*Ref*	*Amount (Rs.)* *Debit*	*Credit*
	Insurance Expenses		24,000	

So adjusting entry at December 2015 in order to adjust the balance

Adjusting Entry

Date		Account Title and Explanations	Ref	Amount (Rs) Debit	Credit
Dec	31				

Case 2: *Asset Method*

General Journal

Date		Account Titles and Explanation	Ref	Amount (Rs) Debit	Credit
2015					
September	1	Prepaid Insurance		24,000	
		Cash			24,000
		(Insurance expense recorded)			

The effect of above regular entry in end of year trial balance is presented below

Trial Balance

S. No.	*Heads of Account*	*Ref*	*Amount (Rs.)*	
			Debit	*Credit*
	Prepaid Insurance		24,000	

So adjusting entry at December 2015 in order to adjust the balance

Adjusting Entry

Date		**Account Title and Explanations**	**Ref**	**Amount (Rs)**	
				Debit	**Credit**
Dec	31				

16.1.2 Unearned revenues

- Income received in advance but has not been earned in accounting period is called unearned revenue
- There are some items of income statement such as interest, rent, discount etc. etc. which might have been received in advance for which the services in full has not been given so for
- Companies record cash received before revenue is earned by increasing (crediting)

Example # 16.2: Rent received for four year in January 01, 2016 of Rs. 80,000. At the end of 2016 accounting period only one year rent is recognized as revenue and remaining liability for next accounting year

Case 1: *Revenue Method*

General Journal

Date		**Account Titles and Explanation**	**Ref**	**Amount (Rs)**	
				Debit	**Credit**
2016					
January	1	Cash		80,000	
		Rent Revenue			80,000
		(Rent revenue recorded)			

The effect of above regular entry in end of year trial balance is presented below

Trial Balance

S. No.	*Heads of Account*	*Ref*	*Amount (Rs.)*	
			Debit	*Credit*
	Rent			80,000

So adjusting entry at December 2016 in order to adjust the balance

Adjusting Entry

Date		**Account Title and Explanations**	**Ref**	**Amount (Rs)**	
				Debit	**Credit**
Dec	31				

Case 2: *Liability Method*

General Journal

Date		**Account Title and Explanations**	**Ref**	**Amount (Rs)**	
				Debit	**Credit**
Jan	1	Cash		80,000	
		Unearned Rent			80,000
		(Unearned rent recorded)			

The effect of above regular entry in end of year trial balance is presented below

Trial Balance

S. No.	*Heads of Account*	*Ref*	*Amount (Rs.)*	
			Debit	*Credit*
	Un earned Rent			80,000

So adjusting entry at December 2016 in order to adjust the balance

Adjusting Entry

Date		Account Titles and Explanation	Ref	Amount (Rs)	
				Debit	Credit
2016					
December	31				

- Deferred…………..... Expenses…………….. Assets ……………..…. Unexpired costs or prepayments
- Deferred…..…………Revenue ……………..Liability ………………. Unearned or Cash received in advance of performing services or selling goods

16.2 Accruals

- The second category of adjusting entries is accruals
- Prior to an accrual adjustment, the revenue account (and the related asset account) or the expense account (and the related liability account) are understated
- Thus, the adjusting entry for accruals will increase both a balance sheet and an income statement account
- Accruals fall into two categories—Accrued Revenues and Accrued Expenses

16.2.1 Accrued Revenue or Receivable Revenue

- Revenue earned but not yet received in cash in accounting year
- Revenues earned but not yet recorded at the statement date are accrued revenues
- Accrued revenues may accumulate (accrue) with the passing of time, as in the case of interest revenue. These are unrecorded because the earning of interest does not involve daily transactions
- Companies do not record interest revenue on a daily basis because it is often impractical to do so

Example # 16.3: Rs. 100,000 fixed deposits amount in bank in July 01, 2015 and contract is to earn 10% per annum at the end of contract year. So in this case we will receive Rs. 10,000 at June 2016, but we have earned interest of six months in this period 20015, so pass adjusted entry

Adjusting Entry

Date		Account Title and Explanations	Ref	Amount (Rs)	
				Debit	Credit
Dec	31				

16.2.2 Accrued Expenses or Outstanding Expenses or Expenses Payable

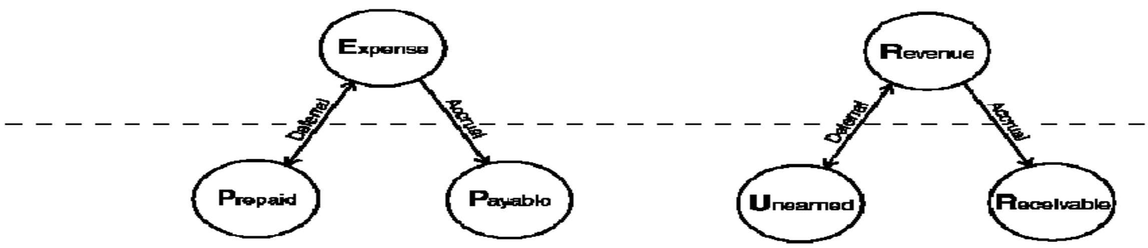
- Expenses incurred but have not been actually paid are called outstanding expenses
- For example, salary for December is generally paid till the 2nd and 3rd January next
- When books of account are closed and Financial Statements are prepared the amount of staff salary for December is treated as an "Outstanding Salaries". It will become liability of business as on the closing date
- Expenses incurred but not yet paid or recorded at the statement date are called accrued expenses. Interest, taxes, and salaries are common examples of accrued expenses

Example # 16.4: At December 31, 2016, Abdul Basit Anwaar Ltd. expects to pay employees' salaries of Rs. 8,400 as a result of work performed since the last pay day

Adjusting Entry

Date		Account Titles and Explanation	Ref	Amount (Rs)	
				Debit	**Credit**
2016					
Dec	31				

- Accrued ……… Revenue ………. Assets ….. Unrecorded revenues (revenues earned, but cash not yet received
- Accrued …. Expenses…….. Liability…… Unrecorded expenses (expenses incurred, but cash not yet been paid



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