Chapter 3 — Adjusting the Accounts

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1 · Why we adjust: accrual accounting

By the end of a period the books are almost right — but not quite. Some things were paid for in advance and have since been used up; some work has been done but not yet billed; some costs have piled up without an invoice. Adjusting entries are the clean-up step that gets every account to its true end-of-period figure before the financial statements are prepared.

The reason this step exists is accrual accounting. Under the accrual basis we record revenue when it is EARNED and expenses when they are INCURRED — regardless of when the cash moves. That is very different from the cash basis, where you would only record something when money changes hands.

Revenue recognition principle: Record revenue in the period it is earned — when the service is performed or the goods are delivered — not necessarily when the cash arrives.

Expense recognition (matching) principle: Record expenses in the same period as the revenues they helped to earn, so profit for the period is measured fairly.

Adjusting entries are how those two principles are enforced at period end. Every adjustment is one of just four patterns — which is the whole map of this chapter.

2 · The one rule behind every adjustment

Before the four patterns, learn the rule they all obey, because it turns adjusting entries from memorization into logic. Every adjusting entry touches exactly one income-statement account (a revenue or an expense) and one balance-sheet account (an asset or a liability). And one account is never involved: Cash. Cash was already handled when the money moved; an adjustment only fixes what is left.

The four patterns split into two families. Deferrals are for cash that already moved — you deferred (delayed) recording the revenue or expense, and now part of it belongs to this period. Accruals are for cash that has NOT moved yet — the revenue or expense happened first, and the cash will follow later.

- Deferral — Prepaid expenses: an asset you paid for is being used up -> move part of the asset to expense.
- Deferral — Unearned revenues: cash collected in advance is now being earned -> move part of the liability to revenue.
- Accrual — Accrued revenues: revenue earned but not yet recorded or received -> record an asset and revenue.
- Accrual — Accrued expenses: an expense incurred but not yet recorded or paid -> record an expense and a liability.

Two patterns start from something already on the books (deferrals); two start from nothing yet recorded (accruals). Keep that split in mind and every adjustment tells you its own entry.

3 · Pattern 1 — Prepaid expenses (asset becomes expense)

A prepaid expense is something you paid for ahead of time and recorded as an asset — supplies in the closet, an insurance policy, rent paid in advance. As the period passes you use part of it up, so the adjusting entry moves the used-up portion out of the asset and into an expense: debit the expense, credit the asset.

Supplies. You started the month with $4,000 of supplies and count $1,500 still on the shelf at month-end. You used $2,500. Adjusting entry: debit Supplies Expense $2,500, credit Supplies $2,500. Supplies now shows its true $1,500 balance.

Prepaid insurance. On the 1st you paid $2,400 for a 12-month policy and recorded Prepaid Insurance. After one month, one-twelfth — $200 — has expired. Adjusting entry: debit Insurance Expense $200, credit Prepaid Insurance $200.

Skip this adjustment and two things go wrong at once: the asset is overstated and the expense is understated, so profit looks too high. That is exactly what the matching principle is there to prevent.

4 · Depreciation: a prepaid expense for long-lived assets

Equipment, vehicles, and buildings are really just very long prepaid expenses: you pay once, then use them up over years. Spreading that cost across the years of use is called depreciation. Each period you record depreciation expense for the portion used up — but with one twist in how you credit it.

Instead of crediting the asset directly, you credit a contra-asset account called Accumulated Depreciation. That keeps the original cost visible while tracking how much has been used up.

Accumulated depreciation: A contra-asset that collects all depreciation taken on an asset so far. Original cost minus accumulated depreciation equals the asset's book (carrying) value.

Straight-line depreciation. Equipment cost $24,000 with a 5-year life and no salvage value. Annual depreciation is $24,000 ÷ 5 = $4,800. Adjusting entry: debit Depreciation Expense $4,800, credit Accumulated Depreciation $4,800. After year one the book value is $24,000 - $4,800 = $19,200.

5 · Pattern 2 — Unearned revenues (liability becomes revenue)

Sometimes a customer pays before you do the work. The cash is real, but you haven't earned it yet, so it was recorded as a liability called Unearned Revenue. As you deliver the service, part of that liability turns into earned revenue. The adjusting entry: debit Unearned Revenue, credit the revenue account.

Unearned revenue. A client pays $6,000 up front for six months of service. After two months you have earned two-sixths — $2,000. Adjusting entry: debit Unearned Revenue $2,000, credit Service Revenue $2,000. The liability drops to $4,000, which is the service you still owe.

Notice it is the mirror image of a prepaid expense. There, an asset became an expense; here, a liability becomes revenue. Same idea, opposite side of the equation.

6 · Pattern 3 — Accrued revenues (earned, not yet recorded)

An accrued revenue is work you have already done that hasn't been billed or recorded yet — the cash has not arrived and no entry has been made. Because it is earned, the revenue recognition principle says record it now. The adjusting entry creates the receivable and the revenue: debit Accounts Receivable, credit the revenue account.

Accrued revenue. By month-end you have performed $1,500 of consulting that you won't invoice until next month. Adjusting entry: debit Accounts Receivable $1,500, credit Service Revenue $1,500. Later, when the client pays, you debit Cash and credit Accounts Receivable — no new revenue, because it was already recorded here.

Miss this one and both revenue and assets are understated — the business looks like it did less work than it actually did.

7 · Pattern 4 — Accrued expenses (incurred, not yet recorded)

An accrued expense is a cost you have run up but not yet paid or recorded — wages your staff have earned since the last payday, interest building on a loan, utilities used but not yet billed. The adjusting entry records the expense and the matching liability: debit the expense, credit a payable.

Accrued salaries. Your team earns $600 a day and has worked three days since the last payday when the period ends. Accrued wages are 3 x $600 = $1,800. Adjusting entry: debit Salaries and Wages Expense $1,800, credit Salaries and Wages Payable $1,800.

Accrued interest. You owe $20,000 on a note at 6% per year. Three months of interest have built up: $20,000 x 6% x 3/12 = $300. Adjusting entry: debit Interest Expense $300, credit Interest Payable $300. Interest is always principal x rate x time.

8 · The adjusted trial balance

Once every adjusting entry is journalized and posted, you prepare one more trial balance — the adjusted trial balance. It lists every account at its corrected end-of-period balance and proves, once again, that total debits equal total credits. This is the version the financial statements are built from.

Adjusted trial balance: A trial balance prepared after all adjusting entries are posted; it shows the true period-end balances and is the basis for the financial statements.

It still has to balance. Because every adjusting entry has an equal debit and credit, the adjusted trial balance stays in balance. If a firm's adjusted debit column totals $66,700, its credit column must total $66,700 too — and from those figures the income statement (revenues minus expenses) and balance sheet fall straight out.

That is the whole chapter: four patterns, one rule (one income-statement account, one balance-sheet account, never Cash), and a final adjusted trial balance that keeps the books honest.