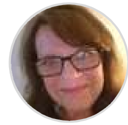
Adjusting Entries: What They Are and Why You Need Them

In order for your financial statements to be accurate, you must prepare and post adjusting entries. We'll explain what they are and why they're so important.



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In order to create accurate financial statements, you must create adjusting entries for your expense, revenue, and depreciation accounts.

Adjusting entries are made at the end of an accounting period to properly account for income and expenses not yet recorded in your general ledger, and should be completed prior to closing the accounting period.

Overview: What are adjusting entries?

Adjusting entries are Step 5 in the accounting cycle and an important part of accrual accounting. Adjusting entries allow you to adjust income and expense totals to more accurately reflect your financial position.

After you prepare your initial trial balance, you can prepare and post your adjusting entries, later running an adjusted trial balance after the journal entries have been posted to your general ledger. The purpose of adjusting entries is to ensure that your financial statements will reflect accurate data.

If adjusting entries are not made, those statements, such as your balance sheet, profit and loss statement, (income statement) and cash flow statement will not be accurate.

Why are adjusting entries important for small business accounting?

1. Revenue will appear too low

12:34

If you earned revenue in the month that has not been accounted for yet, your financial statement revenue totals will be artificially low. For instance, if Laura provided services on January 31 to three clients, it's likely that those clients will not be billed for those services until February.

If Laura does not accrue the revenues earned on January 31, she will not be abiding by the revenue recognition principle, which states that revenue must be recognized when it is earned.

2. Expenses may be understated

As important as it is to recognize revenue properly, it's equally important to account for all of the expenses that you have incurred during the month. This is particularly important when accruing payroll expenses as well as any expenses you have incurred during the month that you have not yet been invoiced for.

For example, your computer crashes in late February. A computer repair technician is able to save your data, but as of February 29 you have not yet received an invoice for his services.

In order to account for that expense in the month in which it was incurred, you will need to accrue it, and later reverse the journal entry when you receive the invoice from the technician.

3. Financial statements will not be accurate

At the end of each month, you should run financial statements: a balance sheet, profit and loss or income statement, and a cash flow statement. Used to make any closing entries, it's important that these statements reflect the true financial position of your company.

Types of adjusting entries

There are five main types of adjusting entries that you or your bookkeeper will need to make monthly. All five of these entries will directly impact both your revenue and expense accounts. They are:

1. Accrued revenues

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Accrued revenue is revenue that has been recognized by the business, but the customer has not yet been billed. Accrued revenue is particularly common in service related businesses, since services can be performed up to several months prior to a customer being invoiced.

Revenue must be accrued, otherwise revenue totals would be significantly understated, particularly in comparison to expenses for the period. For example, Justin owns a CPA firm. His firm does a great deal of business consulting, with some consulting jobs taking months.

Justin will want to accrue the revenue earned in those months before he is able to bill his clients, otherwise his expenses will appear quite high on his income statement, while his revenue will be artificially low.

2. Accrued expenses

An accrued expense is an expense that has been incurred before it has been paid. For example, Tim owns a small supermarket, and pays his employers bi-weekly. In March, Tim's pay dates for his employees were March 13 and March 27.

However, his employees will work two additional days in March that were not included in the March 27 payroll. Tim will have to accrue that expense, since his employees will not be paid for those two days until April. Payroll expenses are usually entered as a reversing entry, so that the accrual can be reversed when the actual expenses are paid.

3. Deferred revenues

Deferred revenue is used when your company receives a payment in advance of work that has not been completed. This can often be the case for professional firms that work on a retainer, such as a law firm or CPA firm.

In many cases, a client may pay in advance for work that is to be done over a specific period of time. When the revenue is later earned, the journal entry is reversed.

4. Prepaid expenses

Prepaid expenses also need to be recorded as an adjusting entry. For instance, if you decide to prepay your rent in January for the entire year, you will need to record the expense each month for the next 12 months in order to account for the rental payment properly.

12:34

If you don't, your financial statements will reflect an abnormally high rental expense in January, followed by no rental expenses at all for the following months.

5. Depreciation expenses

Depreciation expense and accumulated depreciation will need to be posted in order to properly expense the useful life of any fixed asset.

Depreciation is always a fixed cost, and does not negatively affect your cash flow statement, but your balance sheet would show accumulated depreciation as a contra account under fixed assets.

How to prepare your adjusting entries

Each adjusting entry will be prepared slightly differently. Here are examples on how to record each type of adjusting entry.

Step 1: Recording accrued revenue

Any time that you perform a service and have not been able to invoice your customer, you will need to record the amount of the revenue earned as accrued revenue. For example, John owns a cleaning service. He bills his clients for a month of services at the beginning of the following month.

His bill for January is $2,000, but since he won't be billing until February 1, he will have to make an adjusting entry to accrue the $2,000 in revenue he earned for the month of January.

DATE	ACCOUNT	DEBIT	CREDIT

DATE	ACCOUNT	DEBIT	CREDIT
1-31-2020	Accrued Revenue	$2,000	
	Revenue		$2,000

12:34

Once John bills his client in February, he will have to make the following entry:

DATE	ACCOUNT	DEBIT	CREDIT
1-31-2020	Accounts Receivable	$2,000	
	Accrued Revenue		$2,000

The journal entry is completed this way to reverse the accrued revenue, while revenue entry remains the same, since the revenue needs to be recognized in January, the month that it was earned.

Tips for accruing revenue:

Accruing revenue is vital for service businesses that typically bill clients after work has been performed and revenue earned.

- **Know when to use an accrual account and when to use an accounts receivable account:** If you're using manual journals to record accruals, you can make a journal entry directly to your accounts receivable account. However, if you use accounting software, once you bill your client, the invoice balance will be posted automatically to the accounts receivable balance, overstating the balance.
- **Don't forget to reverse your accruals:** If John didn't reverse his original entry, his revenue account would be overstated.

Step 2: Recording accrued expenses

Payroll is the most common expense that will need an adjusting entry at the end of the month, particularly if you pay your employees bi-weekly.

Any hours worked in the current month that will not be paid until the following month must be accrued as an expense. Here is the journal entry for recording accrued payroll expenses:

12:34

DATE	ACCOUNT	DEBIT	CREDIT
1-31-2020	Wages & Salaries Expense	$15,000	
	Wages & Salaries Payable		$15,000

DATE	ACCOUNT	DEBIT	CREDIT
2-10-2020	Wages & Salaries Payable	$15,000	
	Wages & Salaries Expense		$15,000

Tips for accruing expenses:

Be aware that there are other expenses that may need to be accrued, such as any product or service received without an invoice being provided.

- **Make sure that you include all expenses:** While payroll is one of the easier expenses to remember to accrue, it's important that you remember to accrue any expense that has occurred prior to receiving an invoice.
- **Remember to reverse accrued payroll expenses:** You can set up your payroll accrual to reverse automatically.

Step 3: Recording deferred revenue

If your business typically receives payments from customers in advance, you will have to defer the revenue until it's earned. For example, your business offers security services. One of your customers pays you $3,000 in advance for six months of services.

Since the revenue has not yet been earned, it has to be deferred. Here is the journal entry for recording the initial payment:

DATE	ACCOUNT	DEBIT	CREDIT
1-31-2020	Cash	$3,000	
	Deferred Revenue		$3,000

For the next six months, you will need to record $500 in revenue until the deferred revenue balance is zero.

DATE	ACCOUNT	DEBIT	CREDIT
2-10-2020	Deferred Revenue	$500	
	Service Revenue		$500

Tips for recording deferred revenue:

If you receive payment in advance for services that have not yet been performed, the payment must be posted as deferred revenue, with a monthly journal entry necessary until the prepaid revenue has been earned.

- **Payment for more than one month must be deferred:** If you receive a payment for two months, the second month's payment must be deferred.
- **Create a recurring journal entry:** Create a recurring journal entry for advance payments, so you don't have to remember to process a journal entry each

month.

Step 4: Recording prepaid expenses

Prepaid expenses are handled like deferred revenue. For instance, you decide to prepay your rent for the year, writing a check for $12,000 to your landlord that covers rent for the entire year.

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Since you don't want to take a $12,000 expense in January, you will place the $12,000 in a prepaid rent account, and expense it each month for the next 12 months. Your initial journal entry would look like this:

DATE	ACCOUNT	DEBIT	CREDIT
1-31-2020	Prepaid Rent	$12,000	
	Cash		$12,000

For the next 12 months, you will need to record $1,000 in rent expenses and reduce your prepaid rent account accordingly.

DATE	ACCOUNT	DEBIT	CREDIT
1-31-2020	Rent Expense	$1,000	
	Prepaid Rent		$1,000

Tips for recording prepaid expenses:

Common prepaid expenses include rent and professional service payments made to accountants and attorneys, as well as service contracts.

- **Make it recurring:** If you're using accounting software, be sure and make the journal entry recurring for the next 12 months.
- **Be sure to record all prepayments:** Anytime you pay for more than one month of a service, the expense should be divided up between the months that the payment covers.

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Step 5: Recording depreciation expenses

Any time you purchase a big ticket item, you should also be recording accumulated depreciation and your monthly depreciation expense. Most small business owners choose straight-line depreciation to depreciate fixed assets since it's the easiest method to track.

For instance, if you purchase an item for $5,000, with a useful life of five years and a salvage value of $1,000, you can depreciate the asset for five years. based on the number of years that asset will last, making your monthly depreciation total $66.67 per month for five years. To record depreciation, your journal entry would be:

DATE	ACCOUNT	DEBIT	CREDIT
1-31-2020	Depreciation Expense	$66.67	
	Accumulated Depreciation		$66.67

This journal entry can be recurring, as your depreciation expense will not change for the next 60 months, unless the asset is sold.

Tips for recording depreciation expense:

Here are a few ways to make recording depreciation expenses easier:

- **Make your journal entries recurring:** If you're using accounting software, you can choose to make your depreciation expense journal entries recurring, eliminating the need to enter them each month.
- **Create a spreadsheet:** Unless you're using high-end accounting software or your software includes a fixed assets module, chances are that the application does not calculate your depreciation expense for you. To make it easier to track

expenses, especially if using a depreciation method other than straight-line, create a spreadsheet of upcoming depreciation expenses for the year.

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How to prepare your adjusting entries

Whether you're posting in manual ledgers, using spreadsheet software, or have an accounting software application, you will need to create your journal entries manually.

Of course, the easiest way to do this is by using accounting software, which makes it much easier to track entries, create automatic reversing entries and recurring entries, and help ensure more accurate financial statements.

Once you complete your adjusting journal entries, remember to run an adjusted trial balance, which is used to create closing entries.

Adjusting entries are vital

In order to have an accurate picture of the financial health of your business, you need to make adjusting entries. How can you convince a potential investor to invest in your business if your financial statements are inaccurate?

How can you prepare financial projections for the coming months if you don't have an accurate picture of what your monthly revenue and operating expenses are?

If you're still posting your adjusting entries into multiple journals, why not take a look at The Blueprint's accounting software reviews and start automating your accounting processes today.

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