Depreciation expense
Bad debts expense

ADJUSTING ENTRIES

The final accounts are prepared from the trial balance. All revenue and expenditure accounts are transferred to P & L A/c and all assets, liabilities and capital accounts are transferred to balance sheet.

The trial balance is the summary of transactions, which have already been recorded in the books of account during a given period. Trial balance does not include the information concerned with pending transactions. To ensure that the final accounts disclose the true results, it is necessary to take into account all those incomes and expenditures which relate to the given period irrespective of the fact whether they have been received or not, paid or not. Therefore, all outstanding expenses and outstanding incomes are adjusted at the time of the preparation of final accounts. It is done through journal entries called 'Adjusting Entries'.

Accrued expense

The treatment of some of the items is given below:

1. **Prepaid Expenses**

These are expenses, which have been paid in advance of their use or consumption. At the end of the year a part of the payment remains unused and which is treated as **an asset**, because its benefit is to be availed of in future. The example of prepaid expenses are prepaid rent, prepaid insurance, prepaid taxes, prepaid salaries etc. There are two methods of recording prepaid expenses:

(i) Initially recorded as an assets

In this case, advance payment is recorded as an asset, and at the end of the year a part of this advance payment which has been expired or used is transferred to expense a/c,

In this case when cash is paid it is recorded as under:

Date	Particulars	Debit	Credit
	Prepaid expense Cash *(Cash paid in advance for expense)*	XXX	XXX

At the end of the accounting year, an adjusting entry is passed for the expired or used expense as under:

Date	Particulars	Debit	Credit
	Expense Prepaid expense *(To adjust expense for the year)*	XXX	XXX

Example:

Mr. Ahmed paid cash Rs.6,000 on September 1, 2003 for 6 months rent.

Required:

(a) Entry(s) to record the cash payment of advance rent on September 1, 2003

(b) Adjusting entry(s) on December 31, 2003

Solution:

General Journal Entries

Date	Particulars	Debit	Credit
2003 Sep. 1	Prepaid rent Cash *(To record advance payment of rent expense)*	6,000	6,000
Dec. 31	Rent expense Prepaid rent *(To adjust the 4 months rent expense)*	4,000	4,000

(ii) Initially recorded as an expense

In this case, advance payment is recorded as an expense, and at the end of the year a part of this advance payment which has been un-expired or unused is transferred to prepaid expense a/c, and on the 1st day of the following year a reversing entry is made to transferred the prepaid expense in to expense with the same amount.

In this case when cash is paid it is recorded as under:

Date	Particulars	Debit	Credit
	Expense Cash *(Cash paid in advance for expense)*	XXX	XXX

At the end of the accounting year, an adjusting entry is passed for the un-expired or unused expense as under:

Date	Particulars	Debit	Credit
	Prepaid expense Expense *(To adjust prepaid expense)*	XXX	XXX

On the first day of the next accounting period, a **reversing entry** is passed as under:

Expense Dr.
Prepaid expense Cr.
To reverse the entry for expense

Example:
Mr. Ahmed paid cash Rs.6,000 on September 1, 2003 for 6 months rent.

Required:
(a) Entry(s) to record the cash payment of advance rent on September 1, 2003
(b) Adjusting entry(s) on December 31, 2003
(c) Reversing entry(s) on January 1, 2004

Solution:

General Journal Entries

Date	Particulars	Debit	Credit
2003 Sep. 1	Rent expense Cash *(To record advance payment of rent expense)*	6,000	6,000
Dec. 31	Prepaid rent Rent expense *(To adjust the 4 months rent expense)*	2,000	2,000

In this case a **reversing entry** will be passed on the first day of the next accounting period as follows:

General Journal Entries

Date	Particulars	Debit	Credit
2004 Jan. 1	Rent expense Prepaid rent *(To reverse the prepaid rent expense)*	2,000	2,000

Unearned Income
Unearned income is an income received in advance or recorded before it is earned wholly or partly. It must be remembered that advance payments received are usually treated as **liability**. The example of unearned income are unearned commission income, unearned interest income, unearned rent income, unearned subscription income etc.

There are two methods of recording prepaid expenses:

I) **Initially recorded as a liability**
Usually, unearned income is recorded initially in account books as liability. In this case when cash is received it is recorded as under:

Date	Particulars	Debit	Credit
	Cash Unearned income *(Cash received in advance)*	XXX	XXX

At the end of the accounting year, an adjusting entry is passed for the earned income as under:

Date	Particulars	Debit	Credit
	Unearned income Earned income *(To adjust the earned income)*	XXX	XXX

Example:
On September 1, 2003 Mr.Nawaz received 6 months rent in advance in cash Rs.6,000. His accounting year ends on December 31, each year.

Required:
(a) Entry for receiving cash
(b) Adjusting entry as on December 31, 2003

Solution:

General Journal Entries

Date	Particulars	Debit	Credit
2003 Sep. 1	Cash Unearned rent income *(To record advance rent received)*	6,000	6,000
Dec. 31	Unearned rent income Rent income *(To adjust the 4 months rent income)*	4,000	4,000

ii) Initially recorded as an income
Some time, unearned income is recorded initially in account books as an income. In this case when cash is received it is recorded as under:

Cash	Dr.	
Earned income		Cr.
Cash received in advance		

At the end of the accounting year, an adjusting entry is passed for the un-earned income as under:

Earned income	Dr.	
Unearned income		Cr.
To adjust the un-earned income		

On the first day of the next accounting period, a reversing entry is passed as under:

Un-earned income	Dr.	
Earned income		Cr.
To reverse the un-earned income		

Example:
On September 1, 2003 Mr. Nawaz received 6 months rent in advance in cash Rs.6,000. His accounting year ends on December 31, each year.

Required:
(a) Entry for receiving cash
(b) Adjusting entry as on December 31, 2003
(c) Reversing entry on January 1, 2004

Solution:

General Journal Entries

Date	Particulars	Debit	Credit
2003 Sep. 1	Cash Rent income *(To record advance rent received)*	6,000	6,000
Dec. 31	Rent income Unearned rent income *(To adjust the un-earned rent income)*	2,000	2,000

Reversing Entry on January 1, 2004 will be as under:

General Journal Entries

Date	Particulars	Debit	Credit
2004 Jan. 1	Unearned rent income Rent income *(To reverse un-earned rent income)*	2,000	2,000

Accrued Expenses

It means expense payable or expense incurred but not recorded and paid. It is also called outstanding expenses. It is necessary to take these items into the books. The adjusting entry for such items would be as follows:

Types of expenses	Account to be Debited	Account to be Credited
Accrued Salaries	Salaries expense	Salaries payable
Accrued Rent Expense	Rent expense	Rent payable
Accrued Interest Expense	Interest expense	Interest payable
Accrued Taxes	Taxes expense	Taxes payable

Example:

Give adjusting entries of the following items on December 31, 2002:

Accrued Salaries	Rs. 30,000
Accrued Rent Expense	10,000
Accrued Interest Expense	1,500

Solution:

General Journal Entries

Date	Particulars	Debit	Credit
2002 Dec. 31	Salaries expense	30,000	
	Salary payable		30,000
	(To adjust the accrued salaries)		
	Rent expense	10,000	
	Rent payable		10,000
	(To adjust the accrued rent)		
	Interest expense	1,500	
	Interest payable		1,500
	(To adjust the accrued interest)		

Accrued Income

It means income receivable or income earned but not recorded and received. It is also called outstanding income. It is necessary to take these items into the books. The adjusting entry for such items would be as follows:

Types of Income	Account to be Debited	Account to be Credited
Accrued Interest Income	Interest Receivable	Interest Income
Accrued Rent Income	Rent Receivable	Rent Income
Accrued Dividend Income	Dividend Receivable	Dividend Income
Accrued Commission Income	Commission Receivable	Commission Income

Example:

Give adjusting entries of the following items on December 31, 2002:

Accrued Interest Income	Rs.12,000
Accrued Rent Income	45,000
Accrued Dividend Income	18,000
Accrued Commission Income	5,000

Solution:

General Journal Entries

Date	Particulars	Debit	Credit
2002 Dec. 31	Interest receivable	12,000	
	Interest income		12,000
	(To adjust accrued interest income)		
	Rent receivable	45,000	
	Rent income		45,000
	(To adjust accrued rent income)		
	Dividend receivable	18,000	
	Dividend income		18,000
	(To adjust accrued dividend income)		
	Commission receivable	5,000	
	Commission income		5,000
	(To adjust accrued commission income)		

5. **Closing Inventory**
We know that closing inventory is neither recorded in an account nor is it recorded in trial balance. At the time of preparing P & L A/c valuation of inventory must be made for unsold goods since they affect profit. For this purpose closing inventory should be valued at cost price. The adjusting entry will be as under:

Closing Inventory	Dr.	
P & L A/c		Cr.

6. **Depreciation of Assets**
Different fixed assets which are used by the business for the purpose of earning revenue are depreciated gradually. This depreciation charge must be taken into consideration while preparing P & L A/c. The adjusting entry as under:

Depreciation expense	Dr.	
Allowance for depreciation		Cr.

7. **Allowance for Bad Debts**
Bad or doubtful debts are those debts whose recovery is uncertain. Such debts cannot be written off as bad debt because non recovery of such amount is not certain. For such loss, as expected, some provision is made in the form of allowance for bad debts. The entry is:

Bad debts expense	Dr.	
Allowance for bad debts		Cr.

8. **General Reserve or Reserve Fund**
Since the creation of reserve is not a charge against profit, but an appropriation of profit, the entry will be:

P & L A/c	Dr.	
General Reserve		Cr.

9. **Interest on Capital**
Interest on capital is an expense to the business. The adjusting entry as under:

Interest on capital	Dr.	
Capital		Cr.

10. **Interest on Drawing**
Interest on drawings is an income to the business The adjusting entry as under:

Capital	Dr.	
Interest on drawing		Cr.

REVERSING ENTRIES

In adjusting process we adjust and update expenses and income accounts. During the process we record few unrecorded transactions like

1) Merchandise Inventory
2) Depreciation Expense
3) Bad debt Expense
4) Expense from Prepaid
5) Income from Unearned

At the same time we record few adjustments where no new event has taken place we just adjust them to update and make accounts on accrual basis. After adjustment we make closing, opening and financial statements. At the first day of the next financial year we reverse the adjustments where no event has actually occurred but adjusted. Actually these events will occur in the next financial period reversing entry enable to record these events through journal entry when they will actually occur and enable us to separate previous period expenses and income accounts in the current period.

A reversing entry, as the name implies, is the exact reverse of an adjusting entry. It consists of the same accounts and rupees amounts as the adjusting entry, but the debits and credits are reversed, and the date is the beginning of the next accounting period. Only those adjusting entries are reversed in which assets accounts are debited similarly, Liabilities are credited.

Tips: Reversing entry must pass when

1) Any **Asset** a/c (Prepaid/Supplies/any income) is **debited.** (in adjusting entry)
2) Any **Liability** a/c (Exp.payable/Unearned) is **credited.** (in adjusting entry)