Comprehensive Guide to Bookkeeping Adjusting Entries

1. Why Adjusting Entries Are Necessary

Adjusting entries are required under the **Accrual Basis of Accounting**. They serve two primary GAAP (Generally Accepted Accounting Principles) rules:

- **The Revenue Recognition Principle:** Revenue should be recorded in the period it is earned, regardless of when the cash is received.
- **The Matching Principle:** Expenses should be recorded in the same period as the revenues they helped generate.

Without these entries, your Profit & Loss statement might look artificially "profitable" because you haven't recorded unpaid bills, or artificially "poor" because you haven't recorded work finished but not yet billed.

2. Common Types of Adjusting Entries

A. Accrued Expenses (Incurred but not yet paid)

These are costs you have already "used up" but haven't received a bill for or paid yet.

- *Common examples:* Utilities used but not billed, employee wages earned at the end of the month but paid in the next.

B. Accrued Revenues (Earned but not yet billed)

This is income you have earned by providing a service or product, but you haven't sent the invoice yet.

- *Common examples:* A consulting project completed on the 30th of the month that will be invoiced on the 5th of the next month.

C. Deferred Expenses (Prepaid Expenses)

These occur when you pay for something in advance. The adjustment "moves" the portion used from the Balance Sheet (Asset) to the Income Statement (Expense).

- *Common examples:* Prepaid insurance, rent paid in advance, office supplies on hand.

D. Deferred Revenues (Unearned Revenues)

When a customer pays you upfront for work you haven't done yet, you have a liability. The adjustment records the portion of work you actually finished.

- *Common examples:* Retainer fees, annual subscription payments, gift cards.

E. Non-Cash Estimates (Depreciation & Bad Debt)

These record the "wear and tear" on assets or the likelihood that some customers won't pay their bills.

3. Practical Examples & Journal Entries

Example 1: Accrued Wages

Scenario: Employees earned $2,000 in wages during the last week of December, but payday isn't until January 5th.

- **Debit:** Wages Expense $2,000
- **Credit:** Wages Payable ($2,000)
- *Impact:* Corrects the December profit by recognizing the labor cost.

Example 2: Prepaid Insurance

Scenario: You paid $1,200 for a 12-month insurance policy on Dec 1st. On Dec 31st, you have "used" one month ($100).

- **Debit:** Insurance Expense $100
- **Credit:** Prepaid Insurance ($100)
- *Impact:* Reduces the asset (Prepaid Insurance) and records the actual cost for the month.

Example 3: Unearned Revenue

Scenario: A client paid you $3,000 in advance for a 3-month project. At month-end, you have completed the first month of work ($1,000).

- **Debit:** Unearned Revenue $1,000
- **Credit:** Service Revenue ($1,000)
- *Impact:* Reduces the liability (work owed) and records the earned income.

Example 4: Depreciation

Scenario: You bought equipment for $12,000. It is expected to last 5 years ($2,400/year, or $200/month).

- **Debit:** Depreciation Expense $200
- **Credit:** Accumulated Depreciation ($200)
- *Impact:* Recognizes the cost of using the equipment without reducing the original "Equipment" asset account directly.