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SUBJECT- FINANCIAL ACCOUNTING

PREPARATION OF FINANCIAL STATEMENTS - ADJUSTING ENTRIES

Financial statements must be prepared at the end of each accounting period (which is generally the end of each fiscal year). Some transactions begin in 1 year and are not concluded until a later one. This causes problems in accurately matching expenses and revenues in the proper year. Recall that revenues are recognized in the year in which the sale is made, and that all expenses required to generate revenues are recognized in the same year as the associated revenues. If a transaction begins in 1 year and is not concluded until a later one, accountants must adjust the accounting records to indicate what portion of the transaction is a revenue or expense in each of the affected years.

For example, a pharmacy may purchase a computer and use it over a 3 year period. Because the computer is used to generate revenues in each of 3 years, part of its cost must be recognized as an expense in each of those years. To do this, the accountant must make an adjusting entry at the end of each year. The following journal entries record the purchase and depreciation of the computer, which was purchased for ₹3,000, was expected to last 3 years, and was expected to have no residual value. The first entry records the purchase of the computer. This is not an adjusting entry.

1-1-20	Computer	3,000	
	Cash		3,000
	Record purchase of computer		

At the end of 2020 an adjusting entry must be made to recognize that the computer has been used for 1 year and, consequently, that some expense for use of the computer has been incurred. The adjusting entry required is shown.

12-31-20	Depreciation expense	1,000	
	Accumulated depreciation: computer		1,000
	Record depreciation expense on computer for 2020		

A similar entry is required at the end of each of the next 2 years.

12-31-2	Depreciation expense	1,000	
	Accumulated depreciation: computer		1,000
	Record depreciation expense on computer for 202		
12-31-22	Depreciation expense	1,000	
	Accumulated depreciation: computer		1,000
	Record depreciation expense on computer for 2022		

Other common situations in which adjusting entries are used include prepaid and accrued expenses. prepaid expenses occur when a pharmacy must pay for a good or service in a year prior to the one in which the good or service is used. For example a pharmacy may have to pay rent 1 month in advance. So, as of the end of December, the pharmacy would already have paid the rent for January of the next year. The accountant would make an adjusting entry to show that rent had been paid prior to the rent expense being incurred. The prepayment would be listed on the balance-sheet as an asset called prepaid rent.

Accrued expenses occur when, as of the end of the year, the pharmacy has incurred an expense but has not yet paid for it. For example a pharmacy may have incurred an expense for property taxes but not have paid it as of the end of the year. The accountant would note this using an adjusting entry. The unpaid tax expense would appear on the balance-sheet as a liability called an accrued tax payable.