Adjusting Entries in Accounting: Concepts, Journal Entries, and Financial Impact

Introduction

In accounting, **adjusting entries** are essential at the end of every accounting period. They help ensure that the financial statements reflect the actual financial position and performance of a business as per the **accrual basis of accounting**.

These adjustments align income and expenses with the correct accounting period. Below is a detailed explanation of each major year-end adjustment, along with journal entries, examples, effects on financial statements, and references to the **Golden Rules of Accounting**.

Key Adjusting Entries

1. Closing Stock

- **Concept:** Closing stock refers to the value of unsold goods remaining at the end of the financial year.
- **Example:** Purchases = ₹10,00,000, Sales = ₹15,00,000, Closing stock = ₹2,00,000
- **Journal Entry:**
- Closing Stock A/c Dr. 2,00,000
- To Trading A/c 2,00,000
- **Effect on Financial Statements:**
    - **Profit & Loss Account:** Shown in the Trading Account, reducing the cost of goods sold.
    - **Balance Sheet:** Shown under Current Assets.
- **Golden Rule:** Real Account – "Debit what comes in"

2. Outstanding Expense

- **Concept:** These are expenses incurred but not yet paid at the end of the accounting period.
- **Example:** March salary of ₹30,000 remains unpaid.
- **Journal Entry:**
- Salary A/c Dr. 30,000
- To Outstanding Salary A/c 30,000
- **Effect on Financial Statements:**

- **Profit & Loss Account:** Full salary is charged as expense.
- **Balance Sheet:** Shown as Current Liability.

- **Golden Rule:**
  - Nominal Account – "Debit all expenses"
  - Personal Account – "Credit the giver" (the liability)

3. Prepaid Expense

- **Concept:** These are payments made in advance for benefits to be received in future periods.
- **Example:** Insurance of ₹12,000 paid in January for a full year. Only 3 months (₹3,000) are for the current year; ₹9,000 is prepaid.
- **Journal Entry:**
- Prepaid Insurance A/c Dr. 9,000
- To Insurance A/c 9,000
- **Effect on Financial Statements:**
  - **Profit & Loss Account:** Only ₹3,000 is charged.
  - **Balance Sheet:** ₹9,000 shown as Current Asset.
- **Golden Rule:**
  - Real Account – "Debit what comes in" (future benefit)
  - Nominal Account – "Credit what is not expense for this year"

4. Accrued Income

- **Concept:** Income that is earned but not yet received as of the end of the period.
- **Example:** Interest of ₹5,000 earned in March but received in April.
- **Journal Entry:**
- Accrued Interest A/c Dr. 5,000
- To Interest Income A/c 5,000
- **Effect on Financial Statements:**
  - **Profit & Loss Account:** ₹5,000 added to income.
  - **Balance Sheet:** ₹5,000 shown as Current Asset.
- **Golden Rule:**
  - Real Account – "Debit what comes in"
  - Nominal Account – "Credit all incomes"

5. Interest Accrued and Due

- **Concept:** Interest expense that has been incurred and is also due for payment.
- **Example:** ₹15,000 interest on loan is due on 31st March and unpaid.
- **Journal Entry:**
- Interest A/c Dr. 15,000
- To Interest Accrued and Due A/c 15,000
- **Effect on Financial Statements:**
  - **Profit & Loss Account:** ₹15,000 shown under Finance Costs.
  - **Balance Sheet:** Shown as Current Liability.
- **Golden Rule:**
  - Nominal Account – "Debit all expenses"
  - Personal Account – "Credit the giver"

6. Income Received in Advance

- **Concept:** Income received for services yet to be rendered in future periods.
- **Example:** ₹24,000 rent received on 1st March for 12 months. ₹22,000 relates to the next financial year.
- **Journal Entry:**
- Rent Income A/c Dr. 22,000
- To Rent Received in Advance A/c 22,000
- **Effect on Financial Statements:**
  - **Profit & Loss Account:** ₹2,000 shown as income.
  - **Balance Sheet:** ₹22,000 shown as Current Liability.
- **Golden Rule:**
  - Nominal Account – "Debit income not earned"
  - Personal Account – "Credit the obligation"

7. Depreciation

- **Concept:** Systematic allocation of the cost of a tangible asset over its useful life.
- **Example:** Machinery costing ₹5,00,000 with 10% depreciation = ₹50,000
- **Journal Entry:**
- Depreciation A/c Dr. 50,000

- To Machinery A/c 50,000
- **Effect on Financial Statements:**
  - **Profit & Loss Account:** Depreciation charged as expense.
  - **Balance Sheet:** Reduces the value of Machinery (Net Book Value).
- **Golden Rule:**
  - Nominal Account – "Debit all expenses"
  - Real Account – "Credit what goes out" (asset value)

8. Amortization

- **Concept:** Similar to depreciation, but for intangible assets.
- **Example:** Software purchased for ₹1,00,000 amortized over 5 years = ₹20,000 per year.
- **Journal Entry:**
- Amortization A/c Dr. 20,000
- To Software A/c 20,000
- **Effect on Financial Statements:**
  - **Profit & Loss Account:** Amortization shown as expense.
  - **Balance Sheet:** Reduces the intangible asset.
- **Golden Rule:**
  - Nominal Account – "Debit all expenses"
  - Real Account – "Credit asset reduced"

Summary Table

Adjustment	Journal Entry	P&L Impact	Balance Sheet Impact
Closing Stock	Closing Stock A/c Dr. To Trading A/c	Reduces COGS	Current Asset
Outstanding Expense	Expense A/c Dr. To Outstanding Expense A/c	Expense increases	Current Liability
Prepaid Expense	Prepaid Expense A/c Dr. To Expense A/c	Expense decreases	Current Asset
Accrued Income	Accrued Income A/c Dr. To Income A/c	Income increases	Current Asset

Adjustment	Journal Entry	P&L Impact	Balance Sheet Impact
Interest Accrued & Due	Interest A/c Dr. To Interest Accrued and Due A/c	Expense increases	Current Liability
Income Received in Advance	Income A/c Dr. To Income Received in Advance A/c	Income decreases	Current Liability
Depreciation	Depreciation A/c Dr. To Asset A/c	Expense increases	Asset value decreases
Amortization	Amortization A/c Dr. To Intangible Asset A/c	Expense increases	Intangible Asset value decreases

Quiz: Test Your Knowledge

1. What is the journal entry for prepaid rent of ₹5,000?
A. Rent A/c Dr. To Prepaid Rent A/c
B. Prepaid Rent A/c Dr. To Rent A/c
C. Rent A/c Dr. To Cash A/c
D. Prepaid Rent A/c Dr. To Cash A/c

Answer: B
Explanation: Prepaid expense is an asset. We reduce the rent expense by debiting Prepaid Rent and crediting Rent.

2. Depreciation is an example of:
A. Provision
B. Accrued Expense
C. Deferred Income
D. Non-cash Expense

Answer: D
Explanation: Depreciation is a non-cash expense charged to allocate the cost of a tangible asset over its life.

3. Which of the following affects both Trading A/c and Balance Sheet?
A. Depreciation
B. Closing Stock
C. Outstanding Rent
D. Prepaid Insurance

Answer: B
Explanation: Closing stock is credited in Trading A/c and appears under Current Assets in the Balance Sheet.

4. Rent received in advance is shown as:
A. Income in P&L
B. Asset in Balance Sheet
C. Liability in Balance Sheet
D. None of the above

Answer: C
Explanation: Income received in advance is unearned, hence a liability until service is rendered.

5. Accrued income is recorded using which type of account?
A. Personal
B. Real
C. Nominal
D. Mixed

Answer: B
Explanation: Accrued income is a receivable, so it's treated as a Real account – an asset to the business.

Conclusion

Adjusting entries form the backbone of accurate financial reporting. Understanding these adjustments helps maintain compliance with accounting principles and prepares a business for audits, tax filing, and decision-making. Each entry aligns with the **Golden Rules of Accounting**, ensuring clarity, consistency, and correctness.