Accounting cycle essay

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Adjusting entries are normally made at the end of an accounting period to ensure that the financial statements of an entity reflects only revenues attributable to a certain accounting period and expenses incurred in generating those revenues. Adjusting entries, therefore allocate revenues and expenses of an entity to the accounting period in which they occurred in accordance with the accrual-basis of accounting. Adjusting entries are also used to correct errors, to recognize debts that have been paid during the current accounting period and recognize assets that have been purchased and sold throughout the accounting period .

An entity with prepaid expenses and accrued revenues will report a lower net income if the relevant adjusting entries are not made. This is because prepaid expenses will inflate total expenses with expenses that are supposed to be included in the next accounting period and accrued revenue will also not be included in the current accounting period in which they belong. On the other hand, an entity with accrued expenses and prepaid income will report a higher net income if the relevant adjusting entries are not made. This is because expenses attributable to the current accounting period but were paid in previous periods will be excluded while revenues attributable to future periods will be included.

There four types of adjusting entries; expenses accruals, income accruals, expenses deferrals and income deferrals. Expenses accruals are used to include unpaid expenses that have been incurred in the current accounting period. Income accruals are used to include revenues attributable to the current period but cash or cash equivalents have not yet been received. Expense deferral is used to exclude prepaid expenses that are attributable to future accounting periods. Income deferrals are used to exclude cash or cash equivalents received for unearned revenues.

References

Kimmel, P. D., Weygandt, J. J., & Kieso, D. E. (2008). Accounting (3, illustrated ed.). New York: John Wiley and Sons.