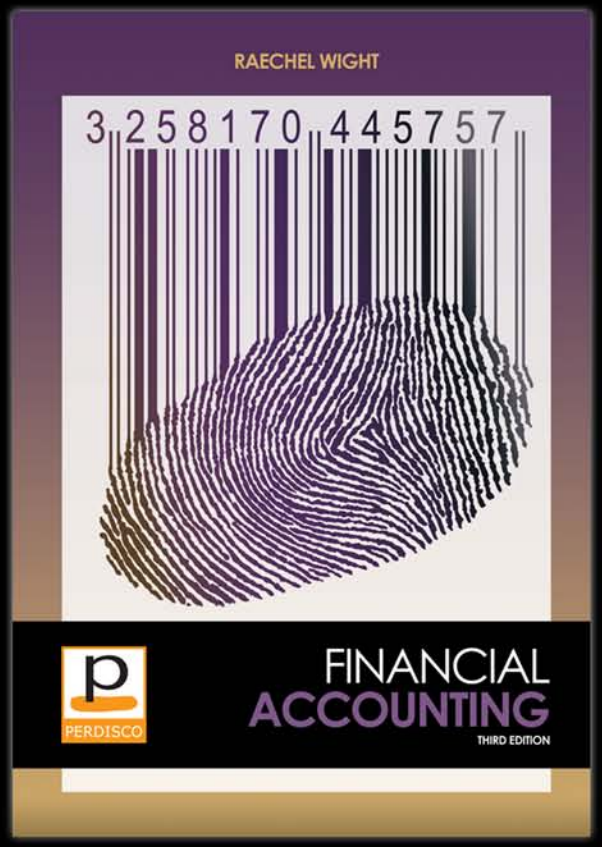

These lecture slides are designed to accompany:

Financial Accounting, Third Edition

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Chapter 4

Completing the accounting cycle

Appendix 4A:
Reversing entries

FINANCIALACCOUNTING

Learning objective

1. Prepare reversing entries and describe their purpose

Reversing entries

- **Reversing entries** are optional journal entries recorded on the first day of a new accounting period
- They reverse the adjustments recorded at the end of the prior period
- Used to simplify the subsequent cash receipt or payment in a following accounting period
- Best illustrated by an example

Example – reversing entry

- Accrued wages expense recorded at the end of the accounting period was $330
- Adjusting and closing entries are recorded on the last day of the accounting period
- Reversing entry is the opposite to the adjusting entry
- Reversing entry is recorded on the first day of the next accounting period

Example – reversing entry

Adjusting entry – accrued wages:				
Dec.	31	Wages Expense	300	
		Wages Payable		300
		(Accrued wages expense.)		

Closing entry – accrued wages:				
Dec.	31	Income Summary	300	
		Wages Expense		300
		(Closing entry - wages expense.)		

Reversing entry – accrued wages:				
Jan.	1	Wages Payable	300	
		Wages Expense		300
		(Reversing entry - wages expense.)		

Example – reversing entry

General ledger accounts:

With reversing entry

Wages Payable				No. 220
Date	**Description**	**Debit**	**Credit**	**Bal.**
Dec. 31	Adjusting		330	330 Cr
Jan. 1	Reversing	330		**0**

Wages Expense				No. 520
Date	**Description**	**Debit**	**Credit**	**Bal.**
Dec. 31	Adjusting	330		330 Dr
Dec. 31	Closing		330	**0**
Jan. 1	Reversing		330	**330 Cr**

Without reversing entry

Wages Payable				No. 220
Date	**Description**	**Debit**	**Credit**	**Bal.**
Dec. 31	Adjusting		330	330 Cr

Wages Expense				No. 520
Date	**Description**	**Debit**	**Credit**	**Bal.**
Dec. 31	Adjusting	330		330 Dr
Dec. 31	Closing		330	**0**

Example – reversing entry

- As a result of the reversing entry, the Wages Expense account has a ***credit*** balance
- This is opposite to the normal debit balance of expense accounts
- This is OK
  - the credit balance is only temporary and will revert back to a normal debit balance by the end of the accounting period either after the subsequent cash payment or the next adjusting entry

Subsequent cash payment

- Journal entry to record the subsequent cash payment of the accrued wages expense differs depending on whether the business uses reversing entries or not
- If the business uses reversing entries, the journal entry simply debits Wages Expense and credits Cash for the full amount of the payment
- If the business does **not** use reversing entries a compound journal entry is required
- Best illustrated by continuing the same example

Example - subsequent cash payment

- For example, the business pays $1,100 to employees for their wages
- $330 related to the wages expense accrued at the end of the last accounting period
- Therefore $1,100 - $330 = $770 related to the wages expense incurred in the current accounting period when the cash payment is made

Example - subsequent cash payment

With reversing entry

Subsequent cash payment with reversing entry:				
Jan.	9	Wages Expense	1,100	
		Cash		1,100
		(Paid wages with cash.)		

Without reversing entry

Subsequent cash payment without reversing entry:				
Jan.	9	Wages Payable	330	
		Wages Expense	770	
		Cash		1,100
		(Paid wages with cash.)		

Example - subsequent cash payment

General ledger accounts:

With reversing entry

Wages Payable				No. 220
Date	**Description**	**Debit**	**Credit**	**Bal.**
Dec. 31	Adjusting		330	330 Cr
Dec. 31	Reversing	330		0

Wages Expense				No. 520
Date	**Description**	**Debit**	**Credit**	**Bal.**
Dec. 31	Adjusting	330		330 Dr
Dec. 31	Closing		330	**0**
Jan. 1	Reversing		330	330 Cr
Jan. 9	**Payment**	**1,100**		**770 Dr**

Without reversing entry

Wages Payable				No. 220
Date	**Description**	**Debit**	**Credit**	**Bal.**
Dec. 31	Adjusting		330	330 Cr
Jan. 9	**Payment**	**330**		**0**

Wages Expense				No. 520
Date	**Description**	**Debit**	**Credit**	**Bal.**
Dec. 31	Adjusting	330		330 Dr
Dec. 31	Closing		330	**0**
Jan. 9	**Payment**	**770**		**770 Dr**

Example - subsequent cash payment

With reversing entry

- After the reversing entry is recorded, the Wages Expense account has a credit balance of $330
- Therefore debiting the Wages Expense account for the full value of the payment ($1,100) leaves a debit balance of $770
- This is the correct amount of Wages Expense that occurred during the period

Example - subsequent cash payment

Without reversing entry

- Where no reversing entries are recorded, the $1,100 payment needs to be allocated between the wages expense incurred this period and the wages payable accrued at the end of the last period
- The accounting records are searched to find the amount of wages expense accrued at the end of the prior accounting period ($330)

Example - subsequent cash payment

Without reversing entry

- The amount of wages expense incurred during the current accounting period is then calculated (1,100 - $330 = $770)
- A compound journal entry is then recorded

Example - subsequent cash payment

- The need to review the prior period adjusting entry and then calculate the values to be journalized is a major disadvantage of **not** using reversing entries
- **Not** using reversing entries increases the chance of making mistakes in the recording process
- Reversing entries simplify the accounting process because the accountant is not required to check the amount of wages accrued at the end of the prior accounting period when recording the subsequent cash payment

Example - subsequent cash payment

- The balance of both the Wages Expense and the Wages Payable accounts at the end of the accounting period end up the same with or without reversing entries
- The important thing to note is that both methods report the correct amount of wages expense in the income statement and the correct amount of wages payable in the balance sheet

The next adjusting entry

- Sometimes the subsequent cash receipt or payment does not occur in the same period as the reversing entry
- In these cases, the next adjusting entry removes the non normal balance of the account
- The value of the next adjusting entry is calculated so that the balance sheet and income statement reports the correct numbers at the end of the period
- Again, best illustrated by an example

Example – the next adjusting entry

- A business records an accrual for utilities expense for $100
- A reversing entry is recorded at the beginning of the following period for $100
- Therefore the Utilities Expense account has a credit balance of $100 and the Utilities Payable account has a balance of $0

Example – the next adjusting entry

- At the end of this accounting period, the utilities bill remained unpaid
- The business estimated it had incurred $130 of utilities expense during the period
- Therefore the business must make an adjusting entry that results in a debit balance of $130 in the Utilities Expense account

Example – the next adjusting entry

- Since the balance of the Utilities Expense account was $100 credit, then debiting the account by $230 (i.e. $100 + $130) gives the correct ending balance of $130 debit
- The corresponding credit of $230 is recorded in the Utilities Payable account
- This is also the correct balance, because the business is liable to pay the $100 expense accrued last period plus the $130 expense accrued this period

Example – the next adjusting entry

The next adjusting entry:				
May.	31	Utilities Expense	230	
		Utilities Payable		230
		(Adjusting entry – utilities expense.)		

Utilities Payable				No. 246
Date	**Description**	**Debit**	**Credit**	**Bal.**
Apr. 30	Adjusting		100	100 Cr
May. 1	Reversing	100		0
May. 31	Adjusting		230	230 Cr

Utilities Expense				No. 546
Date	**Description**	**Debit**	**Credit**	**Bal.**
Apr. 30	Adjusting	100		100 Dr
Apr. 30	Closing		100	**0**
May. 1	Reversing		100	100 Cr
May. 31	Adjusting	230		130 Dr

The purpose of reversing entries

- The purpose of reversing entries is to simplify the recording of transactions in a following accounting period
- But reversing certain adjustments results in adding complexity to the recording process rather than simplifying it
- Therefore not all adjustments are reversed

Types of adjustments that can be reversed

There are four types of adjusting entries that may be reversed with reversing entries:

1. Accrued expenses
2. Accrued revenues
3. Prepaid expenses initially recorded in an expense account
4. Unearned revenues initially recorded in a revenue account

Types of adjustments that can be reversed

Reversing entries are **not** prepared for:

1. Prepaid expenses initially recorded in an asset account
2. Unearned revenues initially recorded in a liability account
3. Depreciation

Recording reversing entries for these types of adjustments adds complexity, not reduces it!

Remember

- Reversing entries are used to simplify the accounting process
- The amounts reported in the financial statements are the same regardless of whether reversing entries are used or not
- Therefore they are an optional step in the accounting cycle