**Step 5 Script**

Slide 1: In this video presentation, we will look at some of the ways we can adjust accounts to make our financial statements more accurate. Remember, a lot of people rely on these statements to make decisions; we owe it to them to make the statements as accurate as possible.

Slide 2: Two principles are involved in the adjusting process: Revenue Recognition and the Matching Principle. We want to recognize as much revenue as has been earned, and we want to make sure that all expenses are matched to that revenue. These adjustments don’t just affect the Income Statement, they also make the Statement of Retained Earnings, the Balance Sheet and resulting Statement of Cash Flows more accurate as well.

Slide3: Revenue Recognition principle states that revenue is recognized when earned, whether cash is received or not. So, if I mow your lawn and you can’t pay me until next week, I can still recognize the revenue, as I did mow the lawn.

Matching Principle states that in order to have the most accurate financial statements, we must match revenues earned in a period with those expenses incurred during the period – those expenses were incurred in the process of generating revenues. So, if my staff helped generate revenues but haven’t yet been paid, I still need to match that expense to revenues.

Slide 4: There are two main types of adjustments: Deferrals and Accruals. To defer means to put off or postpone; to accrue means to gather or accumulate.

With deferrals, cash comes first and we defer the recognition of expenses until they are incurred and revenues are deferred until earned. Examples are Prepaid Insurance, Supplies, Depreciation and Unearned Revenue.

With Accruals, cash comes later and expenses and revenues are recognized when they are incurred and earned, respectively. Examples of accruals are salaries payable, Interest Payable and Interest Receivable, to name a few.

Slide 5: On this slide, we see adjustments we need to make to our Unadjusted Trial Balance from Step 4. If you wish to work along, you can use the Step 5 working papers. In those, I have included any new accounts that arise from the adjustments.

Slide 6: Here, we perform any necessary calculation that will help us to prepare the adjusting entries. I did these in red, so we will know when looking at the ledgers what the entries signify. For most businesses, these adjustments are made at the end of the month and are so dated.

For adjustment a1., we need to account for any of the Prepaid Insurance we have used during the period. Since our policy was for 12 months, we simply divide by12 to account for the one month. We debit insurance expense for 400 and credit the prepaid insurance asset to reflect that now there are 11 months of the policy remaining.

For adjustment a2., we will account for any supplies used in the period. We do a physical count of supplies and determine that $700 worth are still on hand. Since we started with 1,300, we must have used $600 worth of supplies. We debit the expense and credit the asset to show that there are now $700 of supplies on hand.

For adjustment a3., we are going to depreciate our furniture that we previously purchased. While prepaids and supplies are current assets, furniture is a plant asset – its expense will be spread over a much longer period. In this case, we have determined that we will use the asset for 60 months and sell the asset for 1,200 at the end of that time. As such, we divide the asset, less salvage value (7,200 minus 1,200) and divide by 60 months. This gives us a depreciation expense of 100 per month.

For adjustment a4., we need to account for the fact that a customer gave us cash in advance of work being performed. Since we have the cash, we are liable to do the work – so we create an Unearned Revenue liability. No calculations are required.

These first four adjustments are deferrals; the last two will be accruals.

For adjustment a5., we will accrue for wages earned but not yet paid. No calculations required here, either.

For adjustment a6., we need to account for interest on the money borrowed in transaction e. We use the simple interest formula to figure the interest on the note. Assuming the money is borrowed for one year, 10,000 at 6.0% per year for one year equals $600, or 50 per month.

Slide 7: Here we debit Insurance Expense for the 400 we computed and credit Prepaid Insurance for the same amount. Below, we see how this adjusting entry is posted.

Slide 8: For this adjustment, we debit supplies Expense for the 600 we computed and credit the asset Supplies for the same amount. Below the adjusting entry, we see how it is posted to the appropriate ledgers.

Slide 9: Here, we use the 100 we figured to debit Depreciation Expense – Furniture. As a quick aside, most businesses have many different plant assets, so we use the dash to distinguish among them. We introduce a new account – accumulated depreciation – for the credit. Assets must remain on the books at cost, because of the Cost Principle, so, accumulated depreciation helps us to see how much of the cost of an asset has been matched to revenues since was acquired. As with the others, the posted amounts are shown below the adjusting entry.

Slide 10: To record this adjustment, we debit cash to reflect the receipt of cash from our customer and the credit reflects the increase in the liability known as Unearned Revenue. The posting is shown in similar fashion to the other adjustments.

Slide 11: For adjustment a5., we debit Wages Expense by the 2,000 given and credit a Wages Payable liability. Our staff earned the wages and we are liable to pay them. Below the adjusting entry, we can see how it is posted to the proper ledgers.

Slide 12: Finally, to adjust for interest on the note, we debit Interest Expense for the 50 computed and credit an Interest Payable liability – we’re liable to pay interest when the note matures. As with the other adjusting entries, we can see how this one is posted at the bottom of the slide.

Slide 13: So, now that the adjustments have been journalized and posted, we are ready to go to Step 6, which involves preparing the Adjusted Trial Balance. Then, we can move to step 7 and prepare the final financial statements.