15.511 Corporate Accounting Midterm Review

June 23, 2004
Midterm review

• General principles
  – Objectivity, Conservatism, Matching, Revenue Recognition

• Balance Sheet, Income Statement and Statement of Cash Flows

• Recording transactions
  – BSE, Journal Entries, T-accounts
  – Adjusting Entries and Closing Entries

• Ratio analysis

• Revenue recognition and Account Receivables
General principles

• Objectivity Principle
• Conservatism Principle
  – Do we capitalize R&D or expense it?
  – Do we recognize bad debt expense even if we do not know the exact number?
• Matching Principle
  – COGS contains only the cost of the goods sold. The cost of the goods unsold sits in Inventory account.
  – Adjusting entries: prepaid rent
• Revenue Recognition Principle
  – Do we recognize revenue when we receive advances from customers?
Financial Statements

- Assets = Liabilities + Shareholders’ Equity
- Net Income = Revenues – COGS – Expenses
- Ending balance of Retained Earnings = Beginning balance of Retained Earnings + Net Income – Dividends
- Total Cash Flow = CFO+CFI+CFF = Change in the balance of Cash on B/S
Journal Entries and T-accounts

- Increases in assets are debited and recorded on the left side of the T-account
- Increases in liabilities are credited and recorded on the right side of the T-account
- Increases in revenues are credited and recorded on the right side of the T-account
- Increases in expenses are debited and recorded on the left side of the T-account
- Remember that the balances of the permanent accounts carry over to the next year!
Adjusting Entries

– Match expenses to revenues
– Involve at least one temporary account (revenue, expense) and at least one permanent account (asset, liabilities)
– NEVER involve cash
– Expenses and revenues before cash: salary payable, interest receivable
– Cash paid or received before recognizing revenue or expense, eg., Advances from customers, prepaid insurance, depreciation.
Closing Entries

• Bridge Income Statement and Retained Earnings

• Close Revenue into R/E by
  – Dr. Revenues     Cr. R/E

• Close COGS/Expenses into R/E by
  – Dr. R/E       Cr. COGS/Expenses

• How about dividend?
Ratio Analysis

– Profitability
  • ROA, ROE
  • Decomposition of ROA and ROE

– Short-term liquidity
  • Current ratio, quick ratio

– Long-term solvency
  • Debt-to-equity ratio, interest-coverage ratio
Account Receivables

• Allowance for Doubtful Accounts
  – Percentage of sales: BDE=\% of (credit) sales
  – Aging: \text{ADA}\_\text{EB}=\text{Pr(Uncollectible)}\times\text{A/R}

• Journal entries and T-accounts
  – When sales made: Dr. A/R  Cr. Sales
  – When cash collected: Dr. Cash  Cr. A/R
  – To record the bad debt expense: Dr. BDE  Cr. ADA
  – To write off specific accounts: Dr. ADA  Cr. A/R
  – To reinstate the write-off: Dr. A/R  Cr. ADA