15.515 Recitation 2

15.515 RECITATION AGENDA – SESSION 2

¶ Office hours\(^1\):

¶ Principles of financial accounting measurement - Quick Review

¶ Problems

¶ Questions

\(^1\) Best method of reaching me
Quick Review/Must Know!!

Principles of Financial Accounting Measurement
Financial accounting information must be verifiable and neutral/unbiased.

Are the following transactions recorded correctly?:
- Record advertising expenses as an asset and depreciate it over 20 years.

- Mark up the land value on the Balance Sheet at year-end to reflect an increased market value of the land.
¶ **Matching principle:**

- Costs are matched against the benefits that result from them.
- First step in applying the principle is deciding when to recognize the related benefit (i.e. revenue)
- Revenues are booked when assets are created (or liabilities are discharged) and expenses are recorded when liabilities arise (or assets are reduced)

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**Costs - Decision Tree**

- Incur cost in current period
- Decide when benefit is received/recognized
  - Current period - Expense on income statement
  - Future period - Capitalize cost on balance sheet
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**EXAMPLE – MATCHING PRINCIPLE**

1) How should the following transactions be recorded in August?

- In August Sloan receives your tuition for the whole fall semester.

<table>
<thead>
<tr>
<th>Cash</th>
<th>=</th>
<th>Deferred Revenue</th>
<th>Retained Earnings</th>
</tr>
</thead>
<tbody>
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<td></td>
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- Sloan receives $50,000 of electricity from the local utility company in August, but only pays the bill in September.

<table>
<thead>
<tr>
<th>Cash</th>
<th>=</th>
<th>Accounts Payable</th>
<th>Retained Earnings</th>
</tr>
</thead>
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</table>
Principle of revenue recognition: Earned and Realizable

- Company must have produced a significant portion of the sales effort.
- The amount of revenue can be objectively measured.
- The major portion of costs has been incurred and the remaining costs can be reasonably estimated.
- The eventual collection of cash is reasonably assured.

How should the following transactions be recorded?

- An order by fax is received.

- An order is shipped from England to a customer in Iraq which has very strict price controls (thereby making ultimate price uncertain).
Accounts Receivable / Allowance for Doubtful Accounts

- Accounts Receivable (AR) must be recorded at *net realizable value*
  - This requires an estimate of uncollectible accounts, which is represented by the Allowance for Doubtful Accounts (ADA)
  - Bad debts can be estimated in one of two ways:
    1) % of Sales – estimate based on current period sales
    2) Aging Schedule – estimate based analysis of period-end receivables

- Gross AR – ADA = Net AR
- Estimated bad debt expense *increases* ADA (reducing net AR)
- Write-offs occur when the bad debt actually occurs, *decreasing ADA* and *decreasing gross AR* (no impact on net AR)