

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

- $\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$
- $\text{Net Income} = \text{Revenues} - \text{COGS} - \text{Expenses}$
- $\text{Ending balance of Retained Earnings} =$
 $\text{Beginning balance of Retained Earnings} +$
 $\text{Net Income} - \text{Dividends}$
- $\text{Total Cash Flow} = \text{CFO} + \text{CFI} + \text{CFF} = \text{Change}$
 $\text{in the balance of Cash on B/S}$

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: $BDE = \% \text{ of (credit) sales}$
 - Aging: $ADA_{EB} = Pr(\text{Uncollectible}) * A/R$
- 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