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!!

¶ **<u>Principles of Financial Accounting Measurement</u>**

Financial accounting information must be verifiable and neutral/unbiased.

Are the following transactions recorded correctly?:

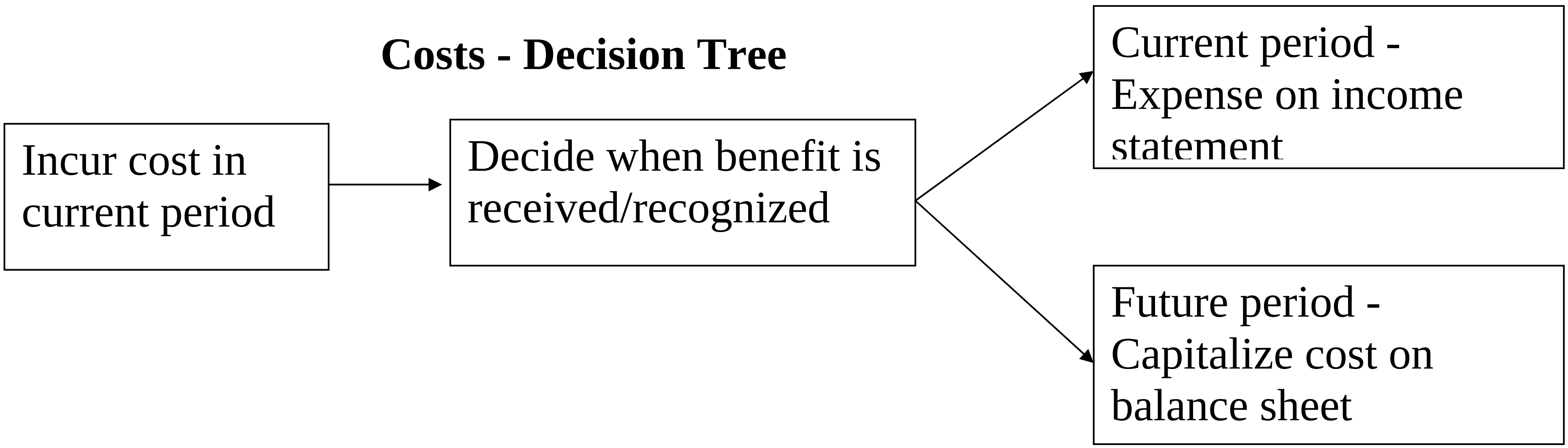
– Record advertising expenses as an asset and depreciate it over 20 years.

– 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)

Costs - Decision Tree



EXAMPLE – MATCHING PRINCIPLE

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

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

Cash	=	**Deferred Revenue**	**Retained Earnings**

– Sloan receives $ 50,000 of electricity from the local utility company in August, but only pays the bill in September.

Cash	=	**Accounts Payable**	**Retained Earnings**

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 *deceasing gross AR* (no impact on net AR)