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Exam II Study Guide

Disclaimer: The following guide is intended to provide a brief overview of some of the material that we have covered in chapters 6-9 in ACCTG 215. This is **not** intended to provide a comprehensive overview of all material that could be examined in Exam II. This should not substitute for your own study nor do I guarantee that it is free from errors. I encourage you to read the textbook on your own and also attempt the "not required" practice problems on Connect. Doing practice problems is very important and helpful in accounting as it is important to learn how to apply the concepts you learn in class! Happy studying! ☺

Chapter 6: Sales Revenue, Receivables and Cash

- Revenue Realization Principle – revenues are recorded when they are earned
- Motivations for accepting credit cards
- Contra-revenue accounts (have a debit balance) – e.g., sales discounts, sales returns and allowances, credit card discounts
- Sales discounts (e.g., 2/10, n/30) vs. trade discounts (e.g., a 20% student discount)
  - Sales discounts are recorded in a separate contra-revenue account
  - Trade discounts affect gross sales revenue (i.e., no contra account is used)
- Net sales = Sales revenue – credit card discounts – sales discounts – sales returns and allowances
- Net sales – Cost of goods Sold = Gross profit
- Accounts receivable are reported at net realizable value → therefore, we need to adjust for amounts that the firm does not expect to collect (kept in contra-asset account called allowance for bad debts- has a credit balance)
- Allowance method – estimates expected amount of bad debts based on current period receivables (see p.285 of textbook for a summary of affects on financial statements):
  - *Making end-of-period adjusting entries to record bad debt expense*

    Bad debt expense (E+/SE-) xx
    Allowance for bad debts (XA+/A-) xx
  - *Writing off specific accounts deemed uncollectible during the period*

    Allowance for bad debts (XA -/A+) xx
    Accounts Receivable (A-) xx
  - *Reversal of a previously written off account*

    Accounts Receivable (A+) xx
    Allowance for bad debts (XA +/A-) xx
    Cash (A+) xx
    Accounts Receivable (A-) xx
- Net accounts receivable = Accounts receivable – Allowance for bad debts
- Estimating bad debts
  - *Percentage of credit sales* – multiply the credit sales by the percentage given in the question to find the bad debt expense for the period, which is directly recorded as an expense in an adjusting entry

- *Aging of accounts receivable*– in this method, use the following steps to solve for bad debt expense: (i) find the balance that the firm wants to have in its allowance for bad debts account at the end of the period via the aging schedule (e.g., page 288), (ii) compare the existing balance in the account to the balance they want (calculated in step(i)) → difference in these amounts gives bad debt expense for the period, which we record as an adjusting entry

- Cash and cash equivalents
- Internal controls over cash – separation of duties and prescribed policies and procedures
- Bank Reconciliation – what is the purpose of performing a bank reconciliation?

Ending cash balance per books	$xxx	Ending cash balance per bank statement	$xxx
+ Interest paid by bank	xx	+ Deposits in transit	xx
– NSF checks/Service charges	xx	– Outstanding checks	xx
± Company errors	xx	± Bank errors	xx
Ending correct cash balance	$xxx	Ending correct cash balance	$xxx

- Key ratios
  - Receivables Turnover = Net (credit) Sales/ Average (Net) Accounts Receivable
  - Average Collection Period = 365/Receivables Turnover
  - Gross profit margin = Gross profit/Net sales

Chapter 7: Cost of Goods Sold and Inventory

- Manufacturing inventory accounts -
  - Raw materials inventory
  - Work-in-process inventory
  - Finished-goods inventory
- Merchandising inventory account -
  - Inventory
- Different methods for tracking inventory (inventory systems)
  - Perpetual –
    - "Perpetually" update the inventory account as transactions occur. Transactions involving inventory are taken directly to the inventory account during the year
    - When recording sales of inventory, will also account for the cost of the item at the time of the sale (Dr: COGS; Cr: Inventory)
  - Periodic –
    - "Periodically" update the inventory account based on physical stock counts of the inventory. Transactions involving inventory are recorded using temporary accounts such as purchases, purchase returns, etc. during the period and then closed into inventory at the end of the period.
    - No journal entry to record the outflow of inventory during the year
    - Need to *calculate cost of goods sold (COGS) at end of the period* – 2 approaches

1. Close temporary accounts such as purchases, purchase returns, freight in to purchases (write these balances down to zero in their ledger) to the inventory account. (e.g. Dr: Inventory; Cr: Freight in). Then calculate *COGS = Beginning Inventory + Net Purchases – Ending Inventory*
2. Journal entry to close these accounts directly (see solutions for section 8)

- Cost of goods available for sale = Beginning Inventory + Net Purchases → will then be split between cost of goods sold and ending inventory (see exhibit 7.3 on page 332)
- Difference in calculating COGS and inventory under perpetual and periodic under the different cost flow methods (recall the method we covered in class to track purchases and sales of inventory)
  - Perpetual – need to account for outflow of goods after each transaction.
  - Periodic – record the total goods available for sale (beginning inventory + purchases) and then account for outflow at the end (after recording all the goods available for sale)
- When doing inventory valuation methods under cost flow assumptions, remember to be careful with your working and read the question carefully to note whether the firm in the problem is using a periodic or perpetual inventory system, and which cost flow method is being used…
- Cost flow assumption methods:
  - Specific identification – track specific items of inventory ("big-ticket" items)
  - First-in, first-out (FIFO) – record the cost of the first units of inventory that were purchased when recording the cost of inventory outflows (will be the same for periodic and perpetual system)
  - Last-in, last-out (LIFO) – record the cost of the last units of inventory that were purchased when recording the cost of inventory outflows (not allowed under IFRS)
  - Average cost – record the average cost of all units of inventory as the cost of inventory outflows (we did not look at average cost under a perpetual system)
- General rule for which costs are included in the cost of inventory: all costs necessary to get the item ready for sale
- F.O.B.
  - …destination – means that the buyer takes control of the inventory when it arrives at its destination (shipping costs are not included in the cost of inventory)
  - …shipping point – means that the buyer takes control of the inventory when it leaves the sellers warehouse (shipping costs are included in the cost of inventory)
- Multiple-step income statement – provides a more detailed description of how cost of goods sold is calculated under a periodic system
- Effect of different inventory valuation methods on COGS, net income, taxes, ending inventory when inventory costs are increasing/decreasing (see page 339-340)
- Lower of cost or market rule (LCM) – adjust any inventory accounts if the cost of these items in the books is higher than the market value (replacement cost) of the items