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Case Analyses of Accounting Concepts and Methodologies

By Austin Newton Garrett

A thesis submitted to the faculty of the University of Mississippi in partial fulfillment of the requirements of the Sally McDonnell Barksdale Honors College.

Oxford

May 2018

Approved By

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Advisor: Dr. Victoria Dickinson

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Reader: Dr. Mark Wilder

2018
Austin Newton Garrett
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ABSTRACT

AUSTIN GARRETT: Case Analyses of Accounting Concepts and Methodologies
(Under the direction of Victoria Dickinson)

As accounting majors in the Sally Barksdale Honors College at Ole Miss, students are offered an honors accounting course that involves weekly class meetings that allow them to satisfy the thesis requirement of the Honors College. Rather than attempting to write a traditional thesis while reporting to the dean during the spring internship, the Honors 420 Alternative Thesis Course allows students to complete twelve different case studies that are ultimately compiled into a final thesis. Each case is completed by using different methods of research and compilation. Research includes analyzing publications in the FASB codification, examining financial statements in cases presented in class, and also searching through the intermediate textbook to discover new ideas and concepts not specifically covered in class. The cases are then compiled using Word and Excel, each requiring a fundamental knowledge of the Microsoft tools. No case uses the exact same incorporations of the methodologies, and thus, a new challenge is presented with each case. Because of the new challenges presented each week, students in the class have an opportunity to develop a deeper knowledge of fundamental concepts in the accounting profession than with a traditional thesis track.

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INTRODUCTION

Summary of Findings: Overall, the class helps students develop an enhanced knowledge of financial reporting, technical skills, theoretical concepts, and research, all equally important in the field of Accounting. Early in the year, the class was introduced to the development of financial statements in Excel. Though a tedious task, the introduction into Excel is important for understanding the way each financial statement relates to the other, due to the ability to link cells and formulas within each document. Once financial statements are crafted, students are then asked to analyze specific values through the use of ratios and yearly comparisons. Though understanding the compilation of the financials is important, the analysis of the statements is the key to comprehending what is occurring from year to year within an organization.

Since many of the topics have not been taught in intermediate at the time they are presented in class, the analysis is challenging at times. Therefore, each case is discussed in teams of three to four in order to alleviate some of the confusion. Throughout school, students are presented with opportunities to work in small groups with their peers on projects, presentations, and other assignments. Unfortunately, the group work assigned in many classes often leads to one student hating group work, as he or she is forced to do the majority of the work. The Honors 420 coursework is different because every student in the class is equally prepared and eager to learn new concepts, and each student offers different interpretations on the new topics. Because individual reports are made by each person, the interpretations differ in every thesis. The experience of working with a high performing team in class directly correlates to the workplace. In most financial organizations, the ability of employees to work collaboratively in teams is prevalent to the success of the

company. Whenever an accounting firm presents to the class, whether a member of the big four or smaller firm, the ability to work in teams is an overarching theme. The experience of discussing and analyzing accounting concepts in teams is one of the most important skills honed during the course. The exposure to more technical team building is a unique opportunity that is not offered with a more traditional thesis.

Though one or two individuals in a group may have a deeper understanding of a particular topic, each group member must develop an in depth comprehension of the content in order to write his or her own analysis. Therefore, an enhanced knowledge of theoretical accounting concepts is developed. Individuals must understand how to calculate certain figures, such as depreciation, income tax expense, and ratios. However, equations can easily be found through research, so the challenge presented in many of the cases is the analysis of the figures. In order to craft a complete report, an understanding of where the calculations come from is necessary. The comprehension of the concepts is developed through a thorough reading of each case, presentations Dr. Dickinson, and oftentimes research. Prior to learning the material in intermediate accounting, each case offered an opportunity to develop an understanding of concepts many students find challenging. For example, case nine presents the idea of stock options and warrants. Within the written case are descriptions of the company's stock option plans that are confusing for a student who has no prior experience with the material. Therefore, the case allows students to search for definitions in the intermediate textbook. Many of the definitions are not found in the text, so Google is the next best option. As all the terms are found, the stock option plans become a little clearer, though still complex for a college student. However, the case is strategically formatted, as it includes a step by step process to understanding the theme. After the

defining of key definitions and ideas, the process includes journal entries and calculations, followed by a final analysis. The defining of terms helps individuals better understand how to create journal entries for the topic. The journal entries help connect the terms with real world applications, and thus, the real world applications create a deeper understanding that allows for the crafting of a final analysis. Much like case nine, many of the cases include a straightforward process that assists in instituting a complete understanding of important theoretical accounting concepts.

The complete understanding of the concepts is not possible without in-depth research. Whether through the use of the FASB codification, Google, or the intermediate textbook, the research is imperative to the completion of the thesis. Similar to group work, research is a predominant aspect of the learning environment at all educational levels. However, the course offers an opportunity to participate in researching that is applicable to the accounting profession that has not been offered in the past. Understanding how to navigate the FASB codification, for example, is a skill that is difficult to possess without the knowledge of how the system is formatted. The skill of researching difficult ideologies and applying the findings to each case is experience that is invaluable in the development of a successful career.

Career Development: The accounting profession offers many opportunities, whether in the field itself or in other areas of business. Though companies generate a high demand for accountants, starting and continuing a successful career presents challenges due to the competitive nature of the career path. As many college students have experienced, the recruitment process for spring internships truly begins Fall of junior year. Students quickly

realize that a strong resume is critical to securing interviews that will hopefully lead to the internship opportunity. However, once an internship is secured, the resume is essentially thrown away and strong performance during the internship is the standard. Though new interns are not introduced into very high level material, the skills acquired in college contribute to performance.

The skills learned in the Honors 420 class help set students apart early in the internship. The ability to work in teams, conduct research, and understand new ideas are all critical to high performance during the internship that are hard skills to develop in a traditional classroom setting. Not only will these skills help one perform well during an internship, but they will also remain prevalent throughout one's career. Researching will always be a necessary skill for accountants as FASB continues to change fundamental accounting concepts affecting how transactions are accounted for in financials. Working in teams will never become outdated as each level of an organization is centered around individuals collaborating and working towards a common goal. Finally, an ability to learn new concepts and ideas will always remain prevalent as strategies and goals change within an organization. All are skills improved upon in the Honors 420 class and are vitally important to a successful career in the field of accounting.

CASE STUDY ONE

Home Heaters: Glenwood vs. Eads

Financial Reporting

Introduction: The following case study compares the financial documents and accounting decisions of two heating companies conducting operations in Colorado: Glenwood Heating and Eads Heaters. Part A involves the first year transactions of each company, while Part B demonstrates differing year-end decisions made by each manager. Also included are the Income Statement, the Statement of Retained Earnings, the Balance Sheet, and the Statement of Cash Flows of each company which have been used to generate ratios necessary to determining the best investment. Upon further examination of the following documents and computations, the decision has been made that Glenwood Heating is the better investment.

Part A:

Table 1-1 Basic Transactions

	Assets						= Liabilities			+ Stockholders' Equity	
	Cash	Accounts receivable	Inventory	Land	Building	Equipment	Accounts payable	Note payable	Interest payable	Common stock	Retained earnings
No. 1	160,000									160,000	
No. 2	400,000							400,000			
No. 3	(420,000)			70,000	350,000						
No. 4	(80,000)					80,000					
No. 5			239,800				239,800				
No. 6		398,500									398,500
No. 7	299,100	(299,100)									
No. 8	(213,360)						(213,360)				
No. 9	(41,000)							(20,000)			(21,000)
No. 10	(34,200)										(34,200)
No. 11	(23,200)										(23,200)
No. 12									6,650		(6,650)
Balances	47,340	99,400	239,800	70,000	350,000	80,000	26,440	380,000	6,650	160,000	313,450

Table 1-2 Basic Trial Balance

	Debits	Credits
Cash	47,340	
Accounts Receivable	99,400	
Inventory	239,800	
Land	70,000	
Building	350,000	
Equipment	80,000	
Accounts payable		26,440
Note payable		380,000
Interest payable		6,650
Common Stock		160,000
Dividend	23,200	
Sales		398,500
Other operating expenses	34,200	
Interest expense	27,650	
Total	971,590	971,590

Part B:

Table 1-3 Glenwood Additional Information

	Assets								
Transactions	Cash	Accounts Receivable	Allowance For Bad Debts	Inventory	Land	Building	Accumulated Depreciation Building	Equipment	Accumulated Depreciation Equipment
Balances: Part A	47,340	99,400		239,800	70,000	350,000		80,000	
Part B (1) Bad Debts			(994)						
Part B (2) COGS				(177,000)					
Part B (3) Depreciation									
Building							(10,000)		
Equipment									(9,000)
Part B (4) Equipment									
Rental Payment	(16,000)								
Part B (5) Income Tax	(30,914)								
Balances	426	99,400	(994)	62,800	70,000	350,000	(10,000)	80,000	(9,000)

	Liabilities			Stockholders' Equity	
	Accounts Payable	Interest Payable	Note Payable	Common Stock	Retained Earnings
Balances: Part A	26,440	6,650	380,000	160,000	313,450
Part B (1) Bad Debts					(994)
Part B (2) COGS					(177,000)
Part B (3) Depreciation					
Building					(10,000)
Equipment					(9,000)
Part B (4) Equipment					
Rental Payment					(16,000)
Part B (5) Income Tax					(30,914)
Balances	26,440	6,650	380,000	160,000	69,542

Table 1-4 Glenwood Trial Balance

	Debits	Credits
Cash	426	
Accounts Receivable	99,400	
Allowance For Bad Debts		994
Inventory	62,800	
Land	70,000	
Building	350,000	
Accumulated Depreciation- Building		10,000
Equipment	80,000	
Accumulated Depreciation- Equipment		9,000
Accounts payable		26,440
Interest payable		6,650
Note Payable		380,000
Common Stock		160,000
Dividend	23,200	
Sales		398,500
Cost of Goods Sold	177,000	
Other operating expenses	34,200	
Bad Debt Expense	994	
Depreciation Expense- Building	10,000	
Depreciation Expense- Equipment	9,000	
Rent Expense	16,000	
Interest expense	27,650	
Provision For Income Tax	30,914	
Total	991,584	991,584

Table 1-5 Eads Additional Information

Transactions	Assets										
	Cash	Accounts Receivable	Allowance For Bad Debts	Inventory	Land	Building	Accumulated Depreciation Building	Equipment	Accumulated Depreciation Equipment	Leased Equipment	Accumulated Depreciation Lease
Balances: Part A	47,340	99,400		239,800	70,000	350,000		80,000			
Part B (1) Bad Debts			(4,970)								
Part B (2) COGS				(188,800)							
Part B (3) Depreciation											
Building							(10,000)				
Equipment									(20,000)		
Part B (4) Equipment											
Lease										92,000	
Lease Payment	(16,000)										
Depreciation											(11,500)
Part B (5) Income Tax	(23,505)										
Balances	7,835	99,400	(4,970)	51,000	70,000	350,000	(10,000)	80,000	(20,000)	92,000	(11,500)

	Liabilities				Stockholders' Equity	
	Accounts Payable	Interest Payable	Note Payable	Lease Payable	Common Stock	Retained Earnings
Balances: Part A	26,440	6,650	380,000		160,000	313,450
Part B (1) Bad Debts						(4,970)
Part B (2) COGS						(188,800)
Part B (3) Depreciation						
Building						(10,000)
Equipment						(20,000)
Part B (4) Equipment						
Lease				92,000		
Lease payment				(8,640)		(7,360)
Depreciation						(11,500)
Part B (5) Income Tax						(23,505)
Balances	26,440	6,650	380,000	83,360	160,000	47,315

Table 1-6 Eads Trial Balance

Eads Heaters, Inc. Trial Balance- Part B		
	Debits	Credits
Cash	7,835	
Accounts Receivable	99,400	
Allowance For Bad Debts		4,970
Inventory	51,000	
Land	70,000	
Building	350,000	
Accumulated Depreciation- Building		10,000
Equipment	80,000	
Accumulated Depreciation- Equipment		20,000
Leased Equipment	92,000	
Accumulated Depreciation- Leased Equipment		11,500
Accounts payable		26,440
Interest payable		6,650
Note Payable		380,000
Lease Payable		83,360
Common Stock		160,000
Dividend	23,200	
Sales		398,500
Cost of Goods Sold	188,800	
Other operating expenses	34,200	
Bad Debt Expense	4,970	
Depreciation Expense- Building	10,000	
Depreciation Expense- Equipment	20,000	
Depreciation Expense- Leased Equipment	11,500	
Interest expense	35,010	
Provision For Income Tax	23,505	
Total	1,101,420	1,101,420

Table 1-7 Glenwood Income Statement

Glenwood Heating, Inc.		
Income Statement		
For Year Ended December 31, 20X1		
Sales		398,500
Cost of Goods Sold		177,000
Gross Profit		221,500
Operating Expenses		
Bad Debt Expense	994	
Depreciation Expense- Building	10,000	
Depreciation Expense- Equipment	9,000	
Rent Expense	16,000	
Other Operating Expenses	34,200	70,194
Income From Operations		151,306
Other Expenses		
Interest Expense		27,650
Income Before Taxes		123,656
Provision for Income Taxes		30,914
Net Income		92,742
Earnings Per Common Share		28.98

Table 1-8 Eads Income Statement

Eads Heaters, Inc.		
Income Statement		
For Year Ended December 31, 20X1		
Sales		398,500
Cost of Goods Sold		188,800
Gross Profit		209,700
Operating Expenses		
Bad Debt Expense	4,970	
Depreciation Expense- Building	10,000	
Depreciation Expense- Equipment	20,000	
Depreciation Expense- Leased Equipment	11,500	
Other Operating Expenses	34,200	80,670
Income From Operations		129,030
Other Expenses		
Interest Expense		35,010
Income Before Taxes		94,020
Provision for Income Taxes		23,505
Net Income		70,515
Earnings Per Common Share		22.04

Table 1-9 Glenwood Retained Earnings

Glenwood Heating, Inc. Statement of Retained Earnings For Year Ended December 31, 20X1	
Retained Earnings January 1, 20X1	0
Plus: Net Income	92,742
	92,742
Less: Dividends	(23,200)
Retained Earnings December 31, 20X1	69,542

Table 1-10 Eads Retained Earnings

Eads Heaters, Inc. Statement of Retained Earnings For Year Ended December 31, 20X1	
Retained Earnings January 1, 20X1	0
Plus: Net Income	70,515
	70,515
Less: Dividends	(23,200)
Retained Earnings December 31, 20X1	47,315

Table 1-11 Glenwood Balance Sheet

Glenwood Heating, Inc.			
Balance Sheet			
For Year Ended December 31, 20X1			
Assets			
Current Assets			
Cash			426
Accounts Receivable		99,400	
Less: Allowance For Bad Debts		(994)	98,406
Inventory			62,800
Total Current Assets			161,632
Property, Plant, and Equipment			
Land		70,000	
Building		350,000	
Equipment		80,000	
Less: Accumulated Depreciation- Building	10,000		
Less: Accumulated Depreciation- Equipment	9,000		
Total Accumulated Depreciation	19,000		481,000
Total Assets			642,632
Liabilities and Stockholders' Equity			
Current Liabilities			
Accounts Payable			26,440
Interest Payable			6,650
Total Current Liabilities			33,090
Long-term Liabilities			
Note Payable			380,000
Total Liabilities			413,090
Stockholders' Equity			
Common Stock		160,000	
Retained Earnings		69,542	
Total Stockholders' Equity			229,542
Total Liabilities and Stockholders' Equity			642,632

Table 1-12 Eads Balance Sheet

Eads Heaters, Inc. Balance Sheet For Year Ended December 31, 20X1			
Assets			
Current Assets			
Cash			7,835
Accounts Receivable		99,400	
Less: Allowance For Bad Debts		4,970	94,430
Inventory			51,000
Total Current Assets			153,265
Property, Plant, and Equipment			
Land		70,000	
Building		350,000	
Equipment		80,000	
Leased Equipment		92,000	
Less: Accumulated Depreciation- Building	10,000		
Less: Accumulated Depreciation- Equipment	20,000		
Less: Accumulated Depreciation- Leased Equipment	11,500		
Total Accumulated Depreciation	41,500		
Total Plant, Property, and Equipment			550,500
Total Assets			703,765
Liabilities and Stockholders' Equity			
Current Liabilities			
Accounts Payable			26,440
Interest Payable			6,650
Total Current Liabilities			33,090
Long-term Liabilities			
Note Payable			380,000
Lease Payable			83,360
Total Liabilities			496,450
Stockholders' Equity			
Common Stock		160,000	
Retained Earnings		47,315	
Total Stockholders' Equity			207,315
Total Liabilities and Stockholders' Equity			703,765

Table 1-13 Glenwood Cash Flows

Glenwood Heating, Inc.		
Statement of Cash Flows		
For Year Ended December 31, 20X1		
Cash Flows From Operating Activities		
Net Income		92,742
Adjustments		
Depreciation Expense- Building	10,000	
Depreciation Expense- Equipment	9,000	
Changes in Current Assets and Liabilities		
Increase in Accounts Receivable	(99,400)	
Increase in Allowance for Bad Debts	994	
Increase in Inventory	(62,800)	
Increase in Accounts Payable	26,440	
Increase in Interest Payable	6,650	(109,116)
Total Cash Flows From Operating Activities		(16,374)
Cash Flows From Investing Activities		
Purchase of Land	(70,000)	
Purchase of Building	(350,000)	
Purchase of Equipment	(80,000)	
Total Cash Flows From Investing Activities		(500,000)
Cash Flows From Financing Activities		
Received Cash for Common Stock	160,000	
Received Cash for Note Payable	380,000	
Paid Cash Dividends	(23,200)	
Total Cash Flows From Financing Activities		516,800
Current Year Cash Flows		426

Table 1-14 Eads Cash Flows

Eads Heaters, Inc. Statement of Cash Flows For Year Ended December 31, 20X1		
Cash Flows From Operating Activities		
Net Income		70,515
Adjustments		
Depreciation Expense- Building	10,000	
Depreciation Expense- Equipment	20,000	
Depreciation Expense- Leased Equipment	11,500	
Changes in Current Assets and Liabilities		
Increase in Accounts Receivable	(99,400)	
Increase in Allowance for Bad Debts	4,970	
Increase in Inventory	(51,000)	
Increase in Accounts Payable	26,440	
Increase in Interest Payable	6,650	(70,840)
Total Cash Flows From Operating Activities		(325)
Cash Flows From Investing Activities		
Purchase of Land	(70,000)	
Purchase of Building	(350,000)	
Purchase of Equipment	(80,000)	
Total Cash Flows From Investing Activities		(500,000)
Cash Flows From Financing Activities		
Received Cash for Common Stock	160,000	
Received Cash for Note Payable	380,000	
Payment of Lease	(8,640)	
Paid Cash Dividends	(23,200)	
Total Cash Flows From Financing Activities		508,160
Current Year Cash Flows		7,835

Table 1-15 Glenwood vs. Eads

	Glenwood	Eads
Current Ratio	4.88	4.63
Acid-Test Ratio	3.02	3.24
Gross Profit Margin	0.56	0.53
Return on Assets	0.14	0.1
Return on Equity	0.4	0.34
Earnings per Share	28.98	22.04
Debt Ratio	0.64	0.71

Final Analysis:

In order to determine which company is the best investment, one must analyze the ratios derived from the financial statements. As seen by the current ratio, Glenwood is better prepared to fulfill short-term and long-term obligations, but Eads's lower acid-test ratio demonstrates the company's ability to pay off current liabilities with its liquid assets. However, Eads has a larger debt ratio thus demonstrating that the company is financing more of its assets with debt than Glenwood. Therefore, the two companies seem to be equally equipped to handle paying off debt, but Glenwood seems to have a slight advantage in terms of debt financing. In regards to profitability, Glenwood has the advantage as demonstrated by the larger gross profit margin, return on assets, and return on equity. Due to its greater profitability, Glenwood's earnings per share remains 31 percent higher than Eads. Overall, Glenwood is the better investment due to its profitability advantage over Eads.

CASE STUDY TWO

Totz Co.

Sales and Related Transactions

Introduction: In Case Study Two, the FASB codification is used as a researching tool to determine how to account for transactions involving the company "Totz." The transactions involve sales, cost of sales, unusual events, and also activity regarding the services of Doodlez, a separate division of Totz.

1. Totz generated $74.5 million in net sales during fiscal 2015 and $86.5 million in net sales during fiscal 2016. Much of the increase derived from service revenues provided by Doodlez. According to Regulation S-X, Rule 5-03, Income Statements, Totz must "state separately: (a) Net sales of tangible products (gross sales less discounts, returns and allowances), (b) operating revenues of public utilities or others; (c) income from rentals; (d) revenues from services; and (e) other revenues." Regulation S-X, Rule 5-03 (b) goes on to state that "each class which is not more than 10 percent of the sum of the items may be combined with another class" (ASC-225-10-S99-2). However, service revenue attributable to Doodlez is greater than ten percent. Therefore, Totz must state its revenue from sales of children's clothing and revenue generated from services offered by Doodlez as separate line items on the face of the income statement for all periods presented.

2. After recording net sales on the income statement, Totz now must decide how it will record cost of sales, which includes direct labor costs for Doodlez employees. Similar to its statement of net sales, Totz must "state separately the amount of: (a) cost of tangible goods sold, (b) operating expenses of public utilities or others, (c) expenses applicable to rental income, (d) cost of services, and (e) expenses applicable to other

revenues" (ASC-225-10-S99-8). The guidance also states that in order "to avoid placing undue emphasis on 'cash flow,' depreciation, depletion, and amortization should not be positioned in the income statement in a manner which results in reporting a figure for income before depreciation" (ASC-225-10-S99-8). Therefore, Totz should not report a gross profit subtotal and must record its expenses incurred when acquiring and producing inventory for sale separately from the direct labor costs for Doodlez employees.

3. Totz experienced a $1.7 million gain on the sale of its old headquarters. ASC-605-10-S99-1 states that "gains or losses from the sale of assets should be reported as 'other general expenses'… Any material item should be stated separately." The codification also states that "a gain or loss recognized on the sale of the long-lived asset (disposal group) that is not a component of an entity shall be included in income from continuing operations before income taxes in the income statement of a business entity" (ASC-360-10-45-5). Additionally, the event is "usual in nature" and is also considered "a consequence of customary and continuing business activities" (ASU-225-45-4). Therefore, in accordance with all the above guidance, the gain will be reported on the income statement before income taxes as operating income.

4. Totz settled a class action lawsuit upon realizing that its fabric suppliers were not providing natural fiber materials. According to the facts presented in the case, the fiber materials provided by the supplier are part of Totz's central operations. Due to the

event's unusual nature, Totz must record the $2.7 million in proceeds on the income statement "as a separate component of income from continuing operations within operating income or, alternatively," disclose the event "in notes to financial statements" (ASU-225-45-16).

CASE STUDY THREE

XXXXX

Basic Accounting Transactions

Introduction: The following case involves accounting for several transactions and how these transactions affect the trial balance of a company. The case includes entries formatted untraditionally in an excel table, both an unadjusted and post-closing trial balance, and a labeling of the entries based on the affect they have on the statement of cash flows. Also included are an updated income statement and balance sheet for the company.

Table 3-1 Entries and Unadjusted Trial Balance:

Cash Flows Key:
Operating
Investing
Financing

	Beginning balance (February 28,2009)	1. Purchase inventory	2. Incur factory wages	3. Sell inventory for cash and on account	4. Pay for inventory	5. Collect receivables	6. Incur SG&A (cash and payable)	7. Pay wages	8. Receive franchise fee	9. Purchase PPE	10. Dividends declared and paid	11. All other transactions	Unadjusted Trial Balance
Cash and cash equivalents	1,253,947			17,000,000	(8,200,000)	4,100,000	(2,000,000)	(6,423,789)	125,000	(498,832)	(2,403,458)	790,224	3,743,092
Accounts receivable	4,229,733			5,000,000		(4,100,000)						(702,207)	4,427,526
Notes receivable, current	-											91,059	91,059
Inventories	4,064,611	7,500,000	6,000,000	(14,000,000)								(66,328)	3,498,283
Deferred income taxes	369,197											92,052	461,249
Other	224,378											(4,215)	220,163
Property and equipment, net	5,253,598									498,832		132,859	5,885,289
Notes receivable, less current portion	124,452											139,198	263,650
Goodwill, net	1,046,944												1,046,944
Intangible assets, net	183,135											(73,110)	110,025
Other	91,057											(3,007)	88,050
Accounts payable	1,074,643	7,500,000			(8,200,000)							503,189	877,832
Accrued salaries and wages	423,789		6,000,000					(6,423,789)					-
Other accrued expenses	531,941						3,300,000					(2,885,413)	946,528
Dividend payable	598,986										3,709	(1)	602,694
Deferred income	142,000								125,000			(46,062)	220,938
Deferred income taxes	827,700											66,729	894,429
Common stock	179,696											1,112	180,808
Additional paid-in capital	7,311,280											315,322	7,626,602
Retained earnings	5,751,017										(2,407,167)		3,343,850
Sales	-			22,000,000								944,017	22,944,017
Franchise and royalty fees	-											5,492,531	5,492,531
Cost of sales	-			14,000,000								693,786	14,693,786
Franchise costs	-											1,499,477	1,499,477
Sales and marketing	-						1,505,431						1,505,431
General and administrative	-						2,044,569					(261,622)	1,782,947
Retail operating	-						1,750,000						1,750,000
Depreciation and amortization	-												-
Interest income	-											(27,210)	(27,210)
Income tax expense	-											2,090,468	2,090,468
A=L+OE+R-E	-	-	-	-	-	-	-	-	-	-	-	-	-

Table 3-2 Entries and Post-Closing Trial Balance:

Cash Flows Key:
Operating
Investing
Financing

		Unadjusted trial balance	12. Adjust for inventory count	13. Record depreciation	14.Wages accrual	15. Consultant's report (no entry)	Pre-closing trial balance	16. Closing entries	Post-closing (ending) balance	Actual February 28, 2010 F/S figures
Dr.	Cash and cash equivalents	3,743,092					3,743,092		3,743,092	3,743,092
	Accounts receivable	4,427,526					4,427,526		4,427,526	4,427,526
	Notes receivable, current	91,059					91,059		91,059	91,059
	Inventories	3,498,283	(216,836)				3,281,447		3,281,447	3,281,447
	Deferred income taxes	461,249					461,249		461,249	461,249
	Other	220,163					220,163		220,163	220,163
	Property and equipment, net	5,885,289		(698,580)			5,186,709		5,186,709	5,186,709
	Notes receivable, less current portion	263,650					263,650		263,650	263,650
	Goodwill, net	1,046,944					1,046,944		1,046,944	1,046,944
	Intangible assets, net	110,025					110,025		110,025	110,025
	Other	88,050					88,050		88,050	88,050
Cr.	Accounts payable	877,832					877,832		877,832	877,832
	Accrued salaries and wages	-			646,156		646,156		646,156	646,156
	Other accrued expenses	946,528					946,528		946,528	946,528
	Dividend payable	602,694					602,694		602,694	602,694
	Deferred income	220,938					220,938		220,938	220,938
	Deferred income taxes	894,429					894,429		894,429	894,429
	Common stock	180,808					180,808		180,808	180,808
	Additional paid-in capital	7,626,602					7,626,602		7,626,602	7,626,602
	Retained earnings	3,343,850					3,343,850	3,580,077	6,923,927	6,923,927
	Sales	22,944,017					22,944,017	(22,944,017)	-	22,944,017
	Franchise and royalty fees	5,492,531					5,492,531	(5,492,531)	-	5,492,531
Dr.	Cost of sales	14,693,786	216,836				14,910,622	(14,910,622)	-	14,910,622
	Franchise costs	1,499,477					1,499,477	(1,499,477)	-	1,499,477
	Sales and marketing	1,505,431					1,505,431	(1,505,431)	-	1,505,431
	General and administrative	1,782,947			639,200		2,422,147	(2,422,147)	-	2,422,147
	Retail operating	1,750,000			6,956		1,756,956	(1,756,956)	-	1,756,956
	Depreciation and amortization	-		698,580			698,580	(698,580)	-	698,580
	Interest income	(27,210)					(27,210)	27,210	-	(27,210)
	Income tax expense	2,090,468					2,090,468	(2,090,468)	-	2,090,468
	A=L+OE+R-E	-	-	-	-	-	-	-	-	(3,580,077)

Table 3-3 Income Statement:

Costs and Expenses	
Cost of sales, exclusive of depreciation and amortization expense of $336,009	14,910,622
Franchise costs	1,499,477
Sales and marketing	1,505,431
General and administrative	2,422,147
Retail operating	1,756,956
Depreciation and amortization	698,580
Total costs and expenses	22,793,213
Operating Income	5,643,335
Other Income (Expenses)	
Interest Expense	-
Interest Income	27,210
Other, net	27,210
Income Before Income Taxes	5,670,545
Income Tax Expense	2,090,468
Net Income	3,580,077
Basic Earnings per Common Share	0.60
Diluted Earnings per Common Share	0.58
Weighted Average Common Shares Outstanding	6,012,717
Dilutive Effect of Employee Stock Options	197,512
Weighted Average Common Shares Outstanding, Assuming Dilution	6,210,238

Table 3-4 Balance Sheet:

Total assets	18,919,914
Liabilities and Stockholders' Equity	
Current Liabilities	
Accounts payable	877,832
Accrued salaries and wages	646,156
Other accrued expenses	946,528
Dividend payable	602,694
Deferred income	220,938
Total current liabilities	3,294,148
Deferred Income Taxes	894,429
Commitments and Contingencies	-
Stockholders' Equity	
Preferred stock, $.10 par value; 250,000 authorized 0 shares issued and outstanding	-
Series A junior participating preferred stock, authorized 50,000 shares	-
Undesignated series, authorized 2,000,000 shares	-
Common stock, $0.03 par value; 100,000,000 shares authorized; 6,026,938 shares issued and outstanding	180,808
Additional paid-in capital	7,626,602
Retained earnings	6,923,927
Total stockholders' equity	14,731,337
Total liabilities and stockholders' equity	18,919,914

CASE STUDY FOUR

Kayla's Craft Shop

Internal Control

Introduction: As the owner of a small craft shop in Oxford, Mississippi, Ms. Kayla Stevens faces the possibility that fraud schemes are occurring at her local business. To safeguard the craft shop's operations, Kayla should implement internal control systems, which include checks and balances created to prevent and detect fraud. Table 4-1 identifies various fraud schemes and recommends internal control procedures to protect the business.

Table 4-1 Analyzing Fraud Schemes and Internal Control Procedures:

Fraud Scheme	Internal Control
Lucy may understate or not record sales as she has the power to both record sales and prepare bank deposits. Thus, Lucy could understate sales and pocket cash that she does not include with the bank deposits.	Separation of duties – Kayla should separate the responsibilities for receiving, depositing, recording, and reconciling cash so that an employee cannot both commit and conceal fraud. Clerks should collect cash during sales. A different individual should record daily sales, and Lucy may prepare bank deposits.
Kayla takes deposits to the bank and reconciles bank statements. This current system allows for embezzlement.	Separation of duties – While dividing all responsibilities may be difficult since the business is small, separation of duties provides greater internal control. One person should take deposits to the bank, and Kayla can reconcile bank statements.
Inventory purchases could be fraudulent since Kayla pays bills and also monitors, records, and orders inventory. One could order inventory but then keep it for personal purposes instead of recording it in the inventory account. One could also write fraudulent checks for fake invoices.	Separation of duties – One clerk will order inventory with Kayla's authorization, and another clerk will record the inventory once it arrives in the store. Then, Kayla can pay invoices. Thus, no one has enough power to steal inventory and hide such behavior in the records.
Clerks may input fake or inaccurate transactions as they have authority for entering all types of transactions in the registers. The shop's new coupon program may allow clerks to enter false discounts and pocket the difference between the money collected and the sale recorded.	Access control – The types of transactions clerks can enter should be restricted, and employees should receive authorization before they can issue a refund or enter any irregular transaction into the cash register. This internal control should limit a clerk's ability to record an erroneous sale.

Fraud Scheme	Internal Control
The clerks' unlimited authority in entering transactions also allows Amanda, Becca, Sam, or Wendy to steal cash directly from the cash register.	Access control – Clerks should not remove cash without authorization. Requiring unique codes to use the register allows employee activity to be tracked, and Kayla should require the reconciliation of cash to check that the amount of cash on hand matches the receipts. To find a culprit, Kayla can give employees vacation and see if cash discrepancies continue or end during a particular employee's time off.
The credit card machine is behind the cash registers. Clerks may steal credit card information or perform fraudulent actions since customers cannot see that their credit card transactions are performed correctly.	Physical control – Kayla should relocate the credit card machine next to the cash registers to ensure that the credit card is swiped and that the transaction is properly completed at the correct price.
The amount recorded for sales or cash earned may be manipulated or presented inaccurately as the store's information system automatically updates inventory accounts while Lucy manually records sales in the accounting software.	Application and access control – Kayla can consider purchasing more sophisticated software that automatically records sales to prevent manipulation of data. If Lucy must enter sales manually, an access control should limit her access to other parts of the accounting software.
If transactions have no identification number or if register tape is not compared to the amount of sales journalized, Lucy or clerks can alter transactions without any matching supplemental records, and their actions will go unnoticed.	Application control – Kayla should use software that indexes each sale with details like the transaction number, date, amount, and clerk's name. This internal control provides unaltered evidence of sales for audits and allows the actual cash balance to be reconciled to the register tape's sales.
Lucy's locked office may allow her to operate in secret.	Physical control – Any business space is property of the business, and Kayla needs a key to Lucy's office to discourage any unauthorized actions. Kayla should keep a safe in her locked office for security.
Kayla has control of all other accounting functions, so she has the ability to commit fraud schemes such as embezzlement, misrepresenting net income, and stealing inventory.	Independent verification – Kayla should consider using an objective accountant to ensure the integrity of financial records. For example, a physical inventory count by external and internal parties can reconcile perpetual inventory records with the true amount of product sold.

CASE STUDY FIVE

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Inventory

Introduction: The following case analyzes the connection between the different inventory accounts raw materials, work-in-process, and finished goods. Also included is a look at the allowance for obsolete inventory, cost of sales, and accounts payable. After calculating ratios, the numbers are used to make an investment decision on what information is needed to ensure the right decision is made.

1. Costs associated with the following inventories:

   Raw Materials: the cost of materials that are on hand that can be traced directly to the end product but have not yet been placed into production.

   Work-In-Process: consists of raw material costs for unfinished goods, direct labor costs assigned to specific material, and overhead costs.

   Finished Goods: costs identified with completed units on hand.

2. Inventories are recorded net of an estimated allowance for obsolete or unmarketable inventory. The estimate derives from current inventory levels, sales trends, and historical experience, in addition to estimates of market conditions and forecasts of future product demand.

3.

   a. The allowance account is included on the balance sheet as a contra asset account thus reducing the inventory account balance.

b. *Gross Amount of Inventory:*

2011: \$233,070 + 10,800 = \$243,870

2012: \$211,734 + 12,520 = \$224,254

The majority of the allowance account is attributable to finished goods inventory. However, some of the write-offs, disposals and other portion of the account is attributable to work-in-process and raw materials.

4. *Journal Entries:*

	Debit	Credit
Cost of Sales	13,348	
Allowance for Obsolete Inventory		13,348
Allowance for Obsolete Inventory	13,348	
Finished Goods Inventory		13,348

5.

Raw Materials	
46,976	442,068
438,561	
\$ 43,469	

Work-in-Process	
1,286	568,735
126,000	
442,068	
\$ 619	

Finished Goods	
184,808	572,549
568,735	13,348
\$ 167,646	

Cost of Sales	
0	
13,348	
572,549	
$ 585,897	

Accounts Payable	
432,197	39,012
	438,561
	$ 45,376

6. *2011 Inventory turnover ratio:*

   575,226 / ((268,591+233,070)0.5) = 2.29

   2012 Inventory turnover ratio:

   585,897 / ((233,070+211,734)0.5) = 2.63

   Typically, a high inventory turnover ratio is preferred when measuring a company's performance, because it demonstrates strong sales performance. The ability of the company to turnover inventory quickly improves liquidity thus improving short-term debt ratios, among other performance indicators. Therefore, the approximate 15% increase from 2.29 to 2.63 is a favorable result for the company.

7. *2011 Inventory holding period:*

   365 / 2.29 = 159.39

   2012 Inventory holding period:

   365/2.63 = 138.78

   Therefore, on average it took the company 160 days to manufacture and sell inventory in 2011 and approximately 139 days in 2012. The decrease directly correlates to the

decrease in inventory turnover as seen in the calculations. In general, companies prefer a lower inventory holding period, as a lower ratio indicates greater efficiency in the production process from raw materials to finished goods, and also in the sales process. In the past year, the company has become more efficient in its inventory management as indicated by the 21-day reduction in the holding period calculation.

8. 13,348/184,808*100 = 7.22%

   7.22% of finished goods is the percentage used to estimate obsolete inventory. As an investor or analyst, I would want additional information on the company's customers in order to get a better idea of how the allowance for doubtful accounts is calculated. Additionally, I would like more information on the company's return policy in order to better understand the allowance for sales returns account balance. I would also like more information on years prior to 2010 to better see the company's growth in the last 5 years. Finally, I would like more information on industry averages to compare with the company's performance ratios.

CASE STUDY SIX

WorldCom

Depreciation

Introduction: The following case includes an analysis of how WorldCom committed accounting fraud in their reporting of line costs in the financials. The incorrect reporting is first described and then corrected, demonstrating how the error impacted the net income of WorldCom which lead to the accounting scandal.

Concepts

a. i. FASB Statement of Concepts No. 6 defines "assets" as the present value of all expected future economic benefits. It defines "expenses" as the outflow of assets or the incurrence of liabilities deriving from operations.

   ii. Costs should be expensed when they have no future economic benefits but capitalized when they have future economic value.

b. After initial capitalization, costs are recognized over time through depreciation and amortization. In the period the costs are incurred, they are recognized in the asset section of the balance sheet. However, costs will be recognized on the income statement overtime as depreciation or amortization.

Process

c. WorldCom reported line costs as $14,739,000,000 for year ended December 31, 2001. These line costs are charges paid to local telephone networks that allowed WorldCom's users to successfully communicate.

   Journal Entry:

	Debit	Credit
Line Costs (Exp)	14,739,000,000	
Cash		14,739,000,000

d. WorldCom improperly capitalized line costs in order to avoid reporting net loss in their financial statements. Because the line costs directly influence the outflow of cash in exchange for services, the costs should have been expensed. Therefore, expenses were underreported on the financial statement resulting in a reported net income instead of a net loss.

e. The line costs noted in the journal entry are allocated among the furniture, fixtures, and other property and equipment on the balance sheet. The line costs therefore are also included with the capital expenditures reported under investing activities in the statement of cash flows.

Journal Entry:

PPE (Asset)	3,055,000,000	
Line Costs (Exp)		3,055,000,000

Analysis

f. *Quarter 1:* 771,000,000/22 * 4/4 = 35,045,455

Quarter 2: 610,000,000/22 * 3/4 = 20,795,455

Quarter 3: 743,000,000/22 * 2/4 = 16,886,364

Quarter 4: 931,000,000/22 * 1/4 = 10,579,546

Total Depreciation Expense = 83,306,820

g. The difference in net income is certainly material. The reported net income for WorldCom in 2001 was 1,501,000,000 as opposed to a net loss of 341,150,567, which should have been reported.

Table 6-1 Restated Net Income

Income before taxes, as reported	2,393,000,000
Depreciation (from part f)	83,306,820
Line costs that were improperly capitalized	(3,055,000,000)
Loss before taxes, restated	(578,693,180)
Income tax benefit	202,542,613
Minority interest	35,000,000
Net loss, restated	341,150,567

CASE STUDY SEVEN

Targa Co.

Employee Expenses

Introduction: In this case, the FASB Codification will be used to find how Targa Company should include expenses and other costs in its financial statements. The following is an analysis of how the Company should account for (1) employee benefits and (2) retraining and relocation costs as described in the Codification.

1. Targa should recognize the one-time termination benefit of $2.5 million as a liability that "exists at the date the plan of termination meets all of the following criteria and has been communicated to employees:
    a. Management, having the authority to approve the action, commits to a plan of termination.
    b. The plan identifies the number of employees to be terminated, their job classifications or functions and their locations, and the expected completion date.
    c. The plan establishes the terms of the benefit arrangement, including the benefits that employees will receive upon termination (including but not limited to cash payments), in sufficient detail to enable employees to determine the type and amount of benefits they will receive if they are involuntarily terminated.
    d. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn" (420-10-25-4).

    In the Inter-Office Memorandum, Targa management commits to a plan, identifies a 10% termination of employees, indicates a total 12 weeks' pay, and Susan Hackmore

expresses that the restructuring is unavoidable. Therefore, Targa meets all of the above criteria.

The FASB Codification states that "nonretirement postemployment benefits offered as special termination benefits to employees shall be recognized as a liability and a loss when the employees accept the offer and the amount can be reasonably estimated." The nonretirement postemployment benefits in this case are the $500,000 severance pay but only if accepted, because Targa "shall not recognize a loss at the date the offer is made based on the estimated acceptance rate" (712-10-25-1).

Similar to the $500,000 severance pay is the $50,000 lump-sum benefit. However, the $50,000 is "in accordance with the facility manager's employment agreement," as stated in the case. Therefore, the recognition of the payment will be slightly different. Though Targa "shall recognize" the $50,000 as "a liability and a loss," Targa will recognize the amount "when it is probable that employees will be entitled to benefits and the amount can be reasonably estimated. The cost of termination benefits recognized as a liability and a loss shall include the amount of any lump-sum payments" (712-10-25-2).

2. The $500,000 relocation cost will be treated as an exit activity (420-10-15-4). Therefore, the $500,000 will be recorded as "a liability" because the cost is "associated with an exit or disposal activity." It will therefore "be recognized in the period in which the liability is incurred" (420-10-25-1).

The $1.5 million staff training cost will be recognized as a liability in the period in which it is incurred, because it is an "operating cost" that "will be incurred as a direct result of a plan" (420-10-25-15).

CASE STUDY EIGHT

Merck & Co., Inc. and GlaxoSmithKline PLC

Shareholder’s Equity

Introduction: In this case, we focused on Merck and Co.'s shareholder's equity. The analysis that follows includes observations involving the company's common stock, treasury stock, and dividends. This analysis includes numbers deriving from the financial statements of the company and also commentary on where and how these numbers were found.

a. i. Merck is authorized to issue 5.4 billion shares.

   ii. Merck has actually issued 2,983,508,675 shares at December 31, 2007.

   iii. The dollar value of common stock reported on the balance sheet can be found by multiplying the number of shares issued by the par value of the stock:

   2,983,508,675 * $0.01 = $29,835,087 or $29.8 million (as reported on the balance sheet).

   iv. 811,005,791 common shares are held in treasury at December 31, 2007.

   v. The number of common shares outstanding at December 31, 2007 is equal to the number of issued shares minus the number of treasury shares.

   2,983,508,675 – 811,005,791 = 2,172,502,884 shares

   vi. On December 31, 2007, if Merck's stock price closes at $57.61 per share, the total market capitalization can be found by multiplying $57.61 by the shares outstanding at that date.

   $57.61 * 2,172,502,884 = $125,157,891,147

c. Companies pay dividends on their common shares because investors may feel more inclined to purchase a company's stock that produces dividends rather than a stock that does not. Many investors may view a dividend payout as a sign that the company is currently thriving and making a profit for the period. However, following most dividend payouts, the company's stock price will fall, typically by the amount of the dividend.

d. Companies may repurchase their stock because they believe their stock is currently undervalued. Therefore, they may repurchase the stock at the low price with the intention of reissuing the stock when the price rises. Another reason a company may repurchase stock is that the company uses equity funding to finance a large part of its operations. However, if the company is not using all of the funding, they are essentially sharing ownership without any benefit. Therefore, the company will repurchase the stock to gain back ownership.

e. *Journal Entry:*

Account	Debit	Credit
Retained Earnings	3,310,700,000	
Dividends Payable		3,400,000
Cash		3,307,300,000

g. i. Merck uses the cost method to account for its treasury stock transactions, as opposed to the par value method, which means that Merck records the treasury stock at the actual cost of the purchase of the stock.

ii. According to Note 11 in the case, Merck repurchased 26.5 million shares on the open market in 2007.

iii. Merck paid $53.95 per share, which equates to 1,429,700,000 total, to buy back its stock in 2007:

1,429,700,000 / 26,500,000 = $53.95

This represents an outflow under the financing section of Merck's statement of cash flows.

iv. Merck does not disclose its treasury stock as an asset, because an asset is a resource that a company owns with the purpose of generating income. Treasury stock does not fall under the category of an asset because a company cannot generate income with its own stock.

i. **Table 8-1 Merck's Yearly Dividend Comparison**

	Merck ($)	
	2007	**2006**
Dividends paid	3,307,300,000	3,322,600,000
Shares outstanding	2,172,502,884	2,167,785,445
Net income	3,275,400,000	4,433,800,000
Total assets	48,350,700,000	44,569,800,000
Operating cash flows	6,999,200,000	6,765,200,000
Year-end stock price	57.61	41.94
Dividends per share	1.52	1.53
Dividend yield (dividends per share to stock price)	2.64%	3.65%
Dividend payout (dividends to net income)	100.97%	74.94%
Dividends to total assets	6.84%	7.45%
Dividends to operating cash flows	47.25%	49.11%

From the end of 2006 to the end of 2007, the dividends paid decreases by about $15 million. Therefore, dividends to net income increases, but the other ratios decrease by the end of 2007.

CASE STUDY NINE

Xilinx, Inc.

Stock-Based Compensation

Introduction: Case Study Nine analyzes the financial statements of Xilinx, Inc. Xilinx offers employee stock option plans, so the following analysis specifically focuses on these stock-based compensation plans.

Concepts

a. Xilinx's employee stock option plan offers employees the option to purchase shares of the company's common stock at 100% fair market value, as recorded on the date of the grant. These options typically retire ten years after the grant, and newly hired employees must work for at least 4 years in order to qualify for the options.

b. Though stock options can offer large payouts to employees in the future, if the stock price falls, the options may become worthless. RSUs, however, offer employees the full value of a company's stock at a future date. For executives, RSUs offer a simpler form of compensation, whereas stock options are subject to varying laws between cities, states, and companies. Overall, stock options present the possibility of becoming a large wealth generator, but RSUs are safer because they guarantee a defined payout in the future.

c. When reading the description of Xilinx's stock options plan, a few key terms need defining:

   Grant date: The date that the fair value of the stock is determined.

   Exercise price: The price at which the option can be purchased.

Vesting period: The amount of time that must pass before an employee may exercise the options.

Expiration date: The last day that the stock options are valid or can be exercised.

Options/RSUs granted: Refers to the options and RSUs offered to employees at a future date.

Options exercised: Options are exercised when an employee purchases common stock before the expiration date.

Options/RSUs forfeited or cancelled: Options are forfeited when they are not exercised by the expiration date.

d. The stock option plan explained on page 63 of Xilinx's annual report incentivizes employees by offering a 24-month purchase right with a short six-month exercise period. 78% of Xilinx's employees participate in the Employee Stock Purchase Plan (ESPP), demonstrating the effectiveness of the ESPP. The stock can be purchased at 85% of the lower of the fair market value at the beginning of the 24-month offering period or at the end of the six-month exercise period. These incentives differ from the employee stock option and RSU plans because the exercise price is defined differently and the exercise period is much shorter with the ESPP than the more traditional plan.

e. Xilinx measures the cost of its stock options plan, RSUs, and stock purchase plan based on the grant-date fair value. The cost is then recorded as compensation expense allocated evenly using the straight-line method over the vesting period. As

previous awards continue to vest, Xilinx records compensation expense for the unvested portion. The alternative transition method is used to calculate the excess tax benefits.

Process

f. i. Xilinx reports $77,862 as total expense (before income taxes) for stock based compensation in 2013.

ii. Xilinx includes this expense on the statement of income under cost of goods sold, research and development expense, and selling, general and administrative expense, because the options are offered to different kinds of employees, who all fall under the three different expense categories.

iii. The 2013 stock based compensation expense is added back to Xilinx's cash flows and is included under the operating section of the statement of cash flows.

iv. The income tax effect of the compensation expense equating to $22,137 for 2013 is recorded as a deferred tax asset.

v. *Journal Entries:*

Cost of Goods Sold	6,356	
Research and Development Expense	37,937	
Selling, General, and Administrative Expense	33,569	
APIC-Stock Options		77,862
Deferred Tax Asset	22,137	
Income Tax Payable		22,137

Analysis

i. i. The article at the end of the case discusses the trend of stock-options going extinct as they are replaced by restricted stock awards. Companies find the restricted stock awards more attractive because of new tax-laws, shareholder demand, and the effects of the most recent financial crisis. I believe most employees prefer these restricted stock options because they are a lot less risky and essentially guarantee future benefits. However, some employees looking to greatly increase their wealth may prefer stock options because of the possibility of large returns.

ii. The trend noted in the article is consistent with Xilinx's reported RSUs and stock-options. Page 62 shows the decreasing amount of options granted each year, as 2,345,000 options were granted in 2010, 207,000 in 2011, and 92,000 in 2012. Page 63 shows the increasing number of RSUs granted, as 3,652,000 were granted in 2010, 4,215,000 were granted in 2011, and 5,239,000 were granted in 2012.

CASE STUDY TEN

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Revenue Recognition

Introduction: In Case Study Ten, four scenarios have been presented in which the five-step revenue model applies. After viewing the Codification, the revenue model will be defined, and the four scenarios will be accounted for by four separate journal entries.

Five Step Revenue Model (ASC 606-10-05-04):

1. Identify the contract(s).
2. Identify the separate performance obligations.
3. Determine the transaction price.
4. Allocate the transaction price to the separate performance obligations.
5. Recognize revenue when the entity satisfies a performance obligation.

Part I:

1. The entry in Part I, 3 is made in accordance with ASC 606-10-05-04, 606-10-25-1 and 606-10-25-30.

2.

   a. The contract is formed when the bartender gives up a large plastic cup of beer for $5, while the college student gives up $5 for a large plastic cup of beer.
   b. The bartender is obligated to give the college student the beer, while the college student is obligated to give the bartender $5.
   c. The transaction price is $5 for a large beer.
   d. The $5 transaction price is allocated directly to the sale of the beer.
   e. The revenue of $5 is recognized upon exchange of beer for cash.

3. *Journal Entry*:

Account	Debit	Credit
Cash	5.00	
Sales		5.00

Part II:

1. The entry in Part II, 3 is made in accordance with ASC 606-10-25-19 to 22 and 606-10-32-31 to 32.

2.

   a. The contract is formed when the bartender gives up the mug and beer for $7, while the college student gives up $7 for the refillable mug and beer.
   b. The bartender is obligated to give the student the mug and beer, while the college student is obligated to give the bartender $7.
   c. The transaction price is $7 for the mug and beer.
   d. Because the standalone prices for beer and the mug are $5 and $3, respectively, the $7 transaction price must be allocated to the beer and to the mug. $2.63 (3/8 * $7) must be allocated to the beer, and $4.37 (5/8 * $7) must be allocated to the mug.
   e. The revenue of $7 is recognized upon exchange of the beer and mug for cash.

3. *Journal Entry*:

Cash	7.00	
Sales- Beer		2.63
Sales- Mug		4.37

Part III:

1. The entry in Part III, 3 is made in accordance with ASC 606-10-25-2 to 6.

2.

   a. The contract is formed when the bartender gives up beer and a coupon for two pretzels for a total of $7, while the college student gives up $7 for the beer and the coupon.
   b. The bartender is obligated to give the student the beer and coupon (as typical business practice), while the student is obligated to give the bartender $7.
   c. The transaction price is $7 for the beer and a coupon for two pretzels to be used at a later date.
   d. Because the standalone prices for beer and two pretzels are $5 and $4, respectively, the $7 transaction price must be allocated to the beer and coupon. $3.89 (5/9 * $7) must be allocated to the beer, and $3.11 (4/9 * $7) must be allocated to the coupon, or unearned sales.
   e. The revenue of $3.89 is recognized upon exchange of the beer for cash, but the 3.11 for the coupon is unearned because the coupon has not been exchanged for the pretzels.

3. *Journal Entry:*

Account	Debit	Credit
Cash	7.00	
Sales- Beer		3.89
Unearned Sales- Pretzel		3.11

Part IV:

1.

a. The contract is formed when the bartender gives up the two pretzels for the coupon, while the student gives up the coupon for two pretzels.

b. The bartender is obligated to give the student two pretzels, while the student is obligated to give the bartender the coupon.

c. The transaction price is the value of the coupon, $3.11, as determined in Part III.

d. The $3.11 is allocated to the sale of the pretzel.

e. The $3.11 is recognized as revenue as the unearned sales from Part III is earned.

2. *Journal Entry:*

Account	Debit	Credit
Unearned Sales- Pretzel	3.11	
Sales- Pretzel		3.11

CASE STUDY ELEVEN

XXXXX

Taxes

Introduction: Case Study Eleven is an analysis of different tax concepts, such as deferred taxes, book income, and many other terms. Much of the case includes definitions of these concepts while also including comparisons of accounting practices, in addition to an analysis of ZAGG Inc.'s financial reports.

Concepts

a. The term book income, also called financial income, refers to the pretax income reported on the income statement. Book income, however, does not normally align with taxable income, because taxable income is income that has been adjusted by deductions or exemptions allowed in the tax year. ZAGG reports its book income on its statement of operations for fiscal 2012 as $23,898,000. ZAGG labels the book income as income before provision for income taxes. The figure includes income from operations less other expenses, thus demonstrating the notion that the value does not include a deduction for income taxes.

b. i. Permanent tax differences are defined as expenses that a company can report when accounting for book income, but a company may not report them for tax purposes. These differences occur because GAAP allows for reporting of permanent tax differences, but the IRC does not. Two examples include meals and entertainment and also penalties and fines, because the IRC does not allow these expenses to be written off on a tax return.

   ii. Temporary tax differences are defined as differences between financial and tax accounting that occur due to inconsistencies in recording revenue and expenses. Therefore, some transactions may be recognized as revenue one year but deferred

for tax purposes the next. On the contrary, a company may report an expense on the tax return in the current year, but, in the future, the expense may be reported for financial purposes. An example of the latter is depreciation because a company may use one depreciation method for tax purposes while using a different, more accelerated method for financial reporting purposes.

iii. Statutory tax rate is defined as the income tax rate mandated by the federal government. The statutory tax rate in the United States is 35%.

iv. Effective tax rate is defined as the average rate that a corporation or individual is taxed and can be found by dividing total tax expense by earnings before taxes. Oftentimes, this tax rate only refers to incomes taxes incurred by taxpayers, not including sales taxes, but in other cases, the effective tax rate excise taxes and payroll taxes.

c. Companies report deferred income taxes as part of their total income tax expense because deferred income tax will become income tax expense at a future date. Companies do not simply report their current tax bill as their income tax expense, because the current tax bill does not account for all taxes for the period.

d. Deferred income tax assets refer to the amount of taxes that a company overpays or pays in advance and thus helps reduce future tax liability. One example of a deferred income tax asset is the carrying over of losses from one fiscal year to another which reduces taxable income reported in future years. Deferred income

tax liabilities are essentially the opposite of deferred income taxes and can be contributed to the tax reported on the financial statement exceeding the tax bill. Varying methods in depreciation may give rise to deferred tax liabilities. Similar to temporary tax differences, if a company uses the straight-line method in its financial books and a different method in its tax books, the company may inevitably be forced to pay higher taxes in the future.

e. A deferred income tax valuation allowance refers to the portion of deferred income tax assets that are deemed unlikely to be realized. If a company predicts that it is more likely than not, the firm will institute a valuation allowance if the business has a history of not fully utilizing its deferred income tax assets. Companies may set up this allowance in accordance with different expiration periods, utilization clauses, and state income tax issues. The company must also consider recent profitability, recent taxable income, and quality of earnings.

f. i. *Journal entry for ZAGG's income tax provision in 2012:*

Account	Debit	Credit
Income Tax Expense	9,393,000	
Net Deferred Tax Asset	8,293,000	
Income Tax Payable		17,686,000

ii. *Journal entry for decomposing the amount of net deferred income taxes:*

Income Tax Expense	9,393,000	
Deferred Tax Asset	8,002,000	
Deferred Tax Liability	291,000	
Income Tax Payable		17,686,000

iii. *Calculation of ZAGG's 2012 effective tax rate:*

ETR = 9,393,000 / 23,898,000 * 100 = 39.3%

Permanent tax differences contribute to the difference between ZAGG's effective tax rate and the statutory rate.

iv. The $13,508,000 recorded as ZAGG's net deferred income tax asset balance at December 31, 2012 can be traced back to ZAGG's balance sheet as $6,912,000 recorded under the current asset section and $6,596,000 as a noncurrent asset. A financial statement user would care about this break down due to the fact that some of the net deferred tax is accounted for in the current period while the remaining balance is allocated to future periods.

CASE STUDY TWELVE

Build-A-Bear Workshop, Inc.

Leases

Introduction: The following case includes an analysis of Build-a-Bear Workshop's lease obligations. In order to better understand how to account for each lease, definitions of four types of leases are included. After better understanding the classifications, entries are made, ratios are calculated, and a final analysis is composed as operating and capital leases are compared.

Concepts

a. Companies may choose to lease assets instead of purchasing them for many reasons. Firstly, a company may want to purchase high-end products that they cannot afford unless they enter into a leasing agreement. Secondly, especially in the technology sector, a company is presented with the opportunity to acquire equipment that is currently the best product on the market, but, in the near future, the product may become outdated. Additionally, a company is allowed more flexibility to address needs the firm may have, whether it is new equipment or new office space. Finally, companies may choose to lease assets, because a company may be able to better manage its balance sheet while also receiving tax benefits.

b. The following are definitions of four different lease types.

   Operating Lease: A contract that allows for the use of an asset, while not transferring ownership to the lessee. In order to be classified as an operating lease, a lease must not meet four criteria, which are listed in part d.

   Capital Lease: Much like an operating lease, it is a long-term contract that allows for use of the asset, but the difference is that more rights and obligations are

generally attached to the contract. If a lease meets at least one of the four criteria listed in part d, it is classified as a capital lease.

Direct-Financing Lease: The lessor treats the lease as a sale, recording it as a receivable and removing the asset from the books. During the lease period, the lessor records the interest revenue as income.

Sales-Type Lease: A sales-type lease is a type of capital lease that is treated similarly to a direct financing lease. However, the profit from the sale is recognized when the lease is signed, equivalent to the present value of the lease payments less the cost of the asset.

c. Accountants distinguish between different types of leases because each type of lease contains different terms and conditions. Because of different terms and conditions, the transfer of assets may be accounted for differently in the financial statements. Due to the different treatments, the leases must be categorized to better understand how they are accounted for individually.

Process

d. i. The lease will be treated as an operating lease because it does not meet any of the following criteria that would result in classifying the lease as a capital lease:

1. The lease life exceeds 75% of the life of the asset.

    -The lease is only for five years which is 20% of the life of the asset.

2. There is a transfer of ownership at the end of the lease term.

    -There is no transfer of ownership at the end of the lease term.

3. There is an option to purchase the asset at a "bargain price" at the end of the lease term.

-There is no option to purchase the asset at a "bargain price."

4. The present value of the lease payments exceeds 90% of the fair market value of the asset.

-The present value of five $100,000 payments does not exceed $1,350,000 which is 90% of $1,500,000.

ii. Build-A-Bear Workshop would make the following entry each year for five years to account for the lease payment each of the five years.

Rent Expense	100,000	
Cash		100,000

iii. Build-A-Bear Workshop would make the following entries each year for the last five years of the lease, if the company was given the option to receive the "first-year free rent."

Year 1:

Rent Expense	100,000	
Deferred Rent		100,000

Year 2-5:

Rent Expense	100,000	
Deferred Rent	25,000	
Cash		125,000

e. i. The amount of rent expense on operating leases in fiscal 2009 can be found in Note 10, Commitments and Contingencies. Build-A-Bear had a base rent expense of $45.9 million and contingent rent of $0.9 million, which equates to a total rent expense of $46.8 million.

ii. The $46.8 million is included in the Income Statement under the selling, general, and administrative expense section for 2009.

Analysis

f. i. The following table includes a calculation of the present value of the future minimum lease payments at January 2, 2010.

Table 12-1 Present Value of Future Minimum Lease Payments

Period	Payment	Present Value Factor	Present Value of Payment
1	50,651	0.9346	47,337
2	47,107	0.8734	41,145
3	42,345	0.8163	34,566
4	35,469	0.7629	27,059
5	31,319	0.7130	22,330
6	25,229	0.6663	16,811
7	25,229	0.6227	15,711
8	25,229	0.5820	14,683
			219,643

ii. If the lease was classified as a capital lease, Build-A-Bear would have made the following entry at January 2, 2010.

Account	Debit	Credit
Property and Equipment	219,643	
Lease Obligation		219,643

v. If Build-A-Bear adopted the alternative approach, or straight-line expensing of the total lease cost, to account for the lease, the following entries would be made in fiscal 2010.

Lease Obligation	35,276	
Interest Expense	15,375	
Cash		50,651

The $15,375 is found by multiplying $219,643 by 0.07.

Depreciation Expense	27,455	
Accumulated Depreciation		27,455

The $27,455 is found by dividing $219,643 by the number of periods, eight.

g. Build-A-Bear Workshop, Inc.'s management is incentivized to structure its lease as an operating lease, because liabilities are increased when the leases are structured as capital leases. The lease obligation entry will not be needed if the lease is operating, and property and equipment will not be reported because ownership of the asset is not expected to change. Therefore, a company's liquidity and solvency ratios are stronger, as indicated in part h.

h. i. The entries made in part f could potentially affect the current ratio, debt-to-equity ratio, and the long-term debt-to-assets ratio at January 2, 2010.

Table 12-2 Operating Lease vs. Capital Lease Ratios

	Operating Lease	Capital Lease
Current Ratio	1.66	1.68
Debt-To-Equity	0.73	1.84
Long-Term Debt-To-Assets	0.13	0.47

The current ratio slightly increases, enhancing the ability of the company to pay-off short term debt, because the lease obligation account is a liability account. The debt-to-equity ratio increases, because the debt is increased by the entry to lease obligation, indicating that the company has increased its use of debt financing. Finally, the long-term debt-to-assets ratio is increased due to the fact that, again, the company has increased its use of debt financing. Capital leases will always yield weaker liquidity and solvency ratios because of the direct increase in liabilities and total assets.