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A Comprehensive Review of Accounting through Case Studies

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by
Edward Dean Ramsey

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
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Approved by

Advisor: Professor Vicki Dickinson

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Abstract

The following thesis is a comprehensive overview of financial accounting concepts. Publicly-trade companies have to follow certain accounting standards, and the concepts that arise have real-world significance. The purpose of this thesis was to gain a better understanding of these underlying concepts and see how they impact the decision-making processes of companies. These concepts are not uniformly applied to all companies, meaning that accountants have to design unique accounting systems within each company. The goal for accountants is to produce a set of financial statements that are free from material misstatements that can be used by investors. Each section of this thesis contains a different case, with each case being based around a certain financial accounting concept. As a result of completing this thesis, I have a better understanding of how the concepts we learned in class apply in real-world situations, which improves my overall understanding of the role of accounting in the modern economy.

Case 1
Home Heaters Company

Glenwood Heating, Inc.

Vs.

Eads Heater, Inc.

Analysis of Financial Statements

Glenwood Heating, Inc, and Eads Heater, Inc, are both heating companies located in different parts of Colorado. These companies operate under similar economic conditions and have identical operations during the year. However, the managers for these companies record and prepare their financial statements in different ways, allowing us to examine the differences between these two companies.

Beginning with the income statement, we can see that these two companies are indeed very similar. Both have gross profits over $200k; both have a sizable amount of selling expenses; and both have sizable amounts of other expenses and losses. Glenwood however takes the cake with the larger amount of net income at $92,742, with Eads trailing behind at $70,515. Just by looking at the income statement, it's difficult to judge how this contrast came to be. In the end, it comes down to Eads having slightly higher expenses and costs in almost every category. Now this could mean either that Eads is not as efficient as Glenwood is at minimizing costs, or that Eads is allowing for higher costs now so that in the future the costs can be reduced by higher sales.

The statements of retained earnings does not give us much info. Since Glenwood's net income is higher than Eads, and they both have the same dividend package, the retained earnings difference is still favoring Glenwood.

The classified balance sheets gives us a large amount of info to analyze. We can see that Ead's assets are reduced by the Allowance for Doubtful Accounts account, showing that Ead's has a bigger problem getting their customers to pay than Glenwood.

The biggest contrast in this financial statement is the leasing of equipment by Eads. They obtained $92,000 of leased equipment. This gives Eads the higher of the Total Assets, $703,765 versus $642, 632. The next part of the balance sheet, the liabilities section, shows that Eads has a larger liability due to a higher lease payable, obviously referring to the leased equipment. Overall, Eads has a higher Assets balance account than Glenwood does; however a higher Assets also means a higher Liabilities balance (not Equity in this case, Eads actually has a lower Equity balance than Glenwood does), which means more risk.

In this case, the statements of cash flows do not tell us much. Both companies are severely lacking liquid capital, and it will hurt both of them now and in the long-run. Eads has a higher negative balance than Glenwood does, but relatively it is a small difference. Both companies are facing the same difficulties when it comes to cash flows.

The financial ratios are able to give us more info on how these companies are competing against each other. Glenwood has a higher current ratio, meaning that Glenwood is more capable of paying its debts over the next year than Eads is. Eads has a higher acid-test ratio, meaning it can eliminate its liabilities faster (or immediately) than Glenwood can. These two ratios in this case are strange because they both relate to eliminating liabilities, but just how fast they need to be eliminated. The income statements and cash flows showed us that Eads has less liquid capital (and overall cash) than Glenwood does, meaning that Glenwood should be able to eliminate its liabilities faster than Eads can.

The Accounts Receivables Turnover and Days to Collect Receivables are the same for both companies. But the next three ratios: inventory turnover, days to sell inventory, and operating cycle all benefit Eads. These ratios mean that Eads is a more efficient operator than Glenwoods is. Eads is able to flip their inventory and finish their operating cycle faster than Glenwood can.

The profitability ratios all favor Glenwood: Gross Profit Margin, Profit Margin, Return on Assets, Return on Equity, and Earnings per Share. Currently, Glenwood is more profitable than Eads is, in more or less all facets of measuring profitability. The income statement already told us that they obtained more income for their first year than Eads, and now the financial statements are telling us that the income statement is backed up by ratios that support Glenwood performing better than Eads.

The Long-Term Solvency Ratios shed a different light on these companies though. The Debt ratio is a huge difference. Eads has a debt ratio of .7, while Glenwood is at 1.55. Glenwood is at a very risky point in its life with a ratio this high. If not lowered, it can severely damage Gleenwood's ability to borrow funds and move capital. The Times Interest Earned ratio does not inform us much of all about these companies. Both are well above the cautionary 2.5 mark, and the level they are at right now is not worth contrasting.

Income Statements Appendix A

Figure 1-1, 1-2: Income Statement

Glendwood Multi-Step Income Statement For the Month Ended		
Sales Revenue		$398,500.00
Cost of Goods Sold		$177,000.00
Gross Profit		$221,500.00
Selling Expenses		
Rent Expense	$16,000.00	
Bad Debt Expense	$994.00	
Depreciation Expense	$19,000.00	
Total Selling Expenses	$35,994.00	
Income from Operations		$185,506.00
Other Expenses and Losses		
Interest Expense	$27,650.00	
Other Operating Expenses	$34,200.00	
Total Other Expenses and Losses	$61,850.00	
Income before Income Taxes		$123,656.00
Provision for Income Taxes		$30,914.00
Net Income		$92,742.00

Eads Multi-Step Income Statement For the Month Ended		
Sales Revenue		$398,500.00
Cost of Goods Sold		$188,800.00
Gross Profit		$209,700.00
Selling Expenses		
Rent Expense	$0.00	
Bad Debt Expense	$4,970.00	
Depreciation Expense	$41,500.00	
Total Selling Expenses	$46,470.00	
Income from Operations		$163,230.00
Other Expenses and Losses		
Interest Expense	$35,010.00	
Other Operating Expenses	$34,200.00	
Total Other Expenses and Losses	$69,210.00	
Income before Income Taxes		$94,020.00
Provision for Income Taxes		$23,505.00
Net Income		$70,515.00

Statements of Retained Earnings

Figure 1-3, 1-4: Statement of Retained Earnings

Glendwood Statement of Retained Earnings For Year Ended December 31, 20X1	
Beginning Retained Earnings	$0.00
Add: Net Income	$92,742.00
Less: Dividends	$23,200.00
Retained Earnings	$69,542.00

Eads Statement of Retained Earnings For Year Ended December 31, 20X1	
Beginning Retained Earnings	$0.00
Add: Net Income	$70,515.00
Less: Dividends	$23,200.00
Retained Earnings	$47,315.00

Classified Balance Sheets

Figure 1-5, 1-6: Balance Sheet

Glenwood Classified Balance Sheet For Year Ended December 31, 20X1	
Assets	
Current Assets	
Cash	$426.00
Accounts Receivable	$99,400.00
Less: Allowance for Doubtful Accounts	$994.00
Inventory	$62,800.00
Total Current Assets	$161,632.00
Plants, Property, Equipment	
Land	$70,000.00
Building	$350,000.00
Equipment	$80,000.00
Leased Equipment	$0.00
Less: Accumulated Depreciation, building	$10,000.00
Less: Accumulated Depreciation, equipment	$9,000.00
Less: Accumulated Depreciation, leased equipment	$0.00
Total Accumulated Depreciation	$19,000.00
Total Plant, Property, Equipment	$481,000.00
Total Assets	$642,632.00
Liabilities	
Current Liabilities	
Accounts Payable	$26,440.00
Interest Payable	$6,650.00
Total Current Liabilities	$33,090.00
Long-Term Liabilities	
Notes Payable	$380,000.00
Lease Payable	$0.00
Total Long-Term Liabilities	$380,000.00
Total Liabilities	$413,090.00
Stockholders' Equity	
Common Stock	$160,000.00
Retained Earnings	$69,542.00
Total Stockholders' Equity	$229,542.00
Total Liabilities and Stockholders' Equity	$642,632.00

Classified Balance Sheets (cont)

Eads Classified Balance Sheet For Year Ended December 31, 20X1	
Assets	
Current Assets	
Cash	$7,835.00
Accounts Receivable	$99,400.00
Less: Allowance for Doubtful Accounts	$4,970.00
Inventory	$51,000.00
Total Current Assets	$153,265.00
Plants, Property, Equipment	
Land	$70,000.00
Building	$350,000.00
Equipment	$80,000.00
Leased Equipment	$92,000.00
Less: Accumulated Depreciation, building	$10,000.00
Less: Accumulated Depreciation, equipment	$20,000.00
Less: Accumulated Depreciation, leased equipment	$11,500.00
Total Accumulated Depreciation	$41,500.00
Total Plant, Property, Equipment	$550,500.00
Total Assets	$703,765.00
Liabilities	
Current Liabilities	
Accounts Payable	$26,440.00
Interest Payable	$6,650.00
Total Current Liabilities	$33,090.00
Long-Term Liabilities	
Notes Payable	$380,000.00
Lease Payable	$83,360.00
Total Long-Term Liabilities	$463,360.00
Total Liabilities	$496,450.00
Stockholders' Equity	
Common Stock	$160,000.00
Retained Earnings	$47,315.00
Total Stockholders' Equity	$207,315.00
Total Liabilities and Stockholders' Equity	$703,765.00

Statements of Cash Flows

Figure 1-7: Statement of Cash Flows

Glendwood Statement of Cash Flows As of December 31, 20X1		
Cash Flows from Operating Activities		
Net Income		$92,742.00
Adjustments to Reconcile Net Income to Net Cash		
Depreciation Expense	$19,000.00	
Increase in Inventory	$62,800.00	
Increase in Accounts Receivable	$99,400.00	
Increase in Accounts Payable	$26,440.00	
Increase in Interest Payable	$6,650.00	$110,110.00
Net Cash Provided by Operating Activities		-$17,368.00
Cash Flows from Investing Activities		
Purchase of Building		-$350,000.00
Purchase of Land		-$70,000.00
Purchase of Equipment		-$80,000.00
Net Cash used by Investing Activities		-$500,000.00
Cash Flows from Financing Activities		
Increase in Notes Payable		$380,000.00
Payment of Cash Dividends		$23,200.00
Issuance of Common Stock		$160,000.00
Net Cash Provided by Financing Activities		-$196,800.00
Net Increase in Cash		-$714,168.00
Cash at Beginning of Year		$0.00
Cash at End of Year		-$714,168.00

Financial Ratios

Glendwood

Liquidity Ratios	
Current Ratio	4.8846177093
Acid-Test	3.0168026594
Accounts Receivables Turnover	4.009054326
Days to Collect Receivables	91.04391468
Inventory Turnover	2.8184713376
Days to Sell Inventory	129.50282486
Operating Cycle	220.54673954
Profitability Ratios	
Gross Profit Margin	0.5558343789
Profit Margin	0.232727729
Return on Assets	0.144315876
Return on Equity	0.4040306349
Earnings per Share	28.981875
Long-Term Solvency Ratios	
Debt	1.5556706771
Times Interest Earned	6.7090777577

Eads

Liquidity Ratios	
Current Ratio	4.6317618616
Acid-Test	3.2407071623
Accounts Receivables Turnover	4.009054326
Days to Collect Receivables	91.04391468
Inventory Turnover	3.7019607843
Days to Sell Inventory	98.596398305
Operating Cycle	189.64031299
Profitability Ratios	
Gross Profit Margin	0.5262233375
Profit Margin	0.1769510665
Return on Assets	0.1001967986
Return on Equity	0.3401345778
Earnings per Share	22.0359375
Long-Term Solvency Ratios	
Debt	0.7054201331
Times Interest Earned	4.6623821765

Case 2
Molson Coors Brewing Company

Profitability and Earnings Persistence

CONCEPTS

a. Sales, excise taxes, net sales, costs of goods sold, marketing, general, and administrative expenses; special items, Equity Income in MillerCoors, Other income, Income tax benefit, Income (loss) from discontinued operations, net of tax; Net (income) loss attributable to noncontrolling interests
b. Classify to permit users to assess the amounts, timing, and uncertainty of future cash flows and to evaluate the company's liquidity, financial flexibility, profitability, and risk.
c. Financial statement users want to know the persistent income because persistent income is income from operations (or nonoperations) that will continue to happen every year.
d. Comprehensive income is the change in equity (net assets) of an entity during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by nonowners and distributions to owners.

PROCESS

e. The differences between "Sales" and "Net Sales" is that net sales is sales after the excises taxes are taken out of it. Excise taxes are a kind of sales tax that are only levied onto specific products (alcohol, tobacco, gasoline, etc). The excise tax, unlike normal sales tax, is not on a consumer receipt. The taxes are only visible to the companies that provide the goods or services, in this case Molson Coors. Molson Coors distinguishes between Sales and Net Sales by subtracting out Excise taxes because, unlike normal income taxes, this tax is taken directly every unit sold, aka their sales.
f.
    i. Molson Coors includes in their Special items, net of tax: infrequent or unusual items, impairment or asset abandonment-related losses, restructuring charges and other atypical employee-related costs, or fees on termination of significant operating agreements and gains (losses) on disposal of investments.
    ii. Molson Coors includes these items in their operating expenses, even though they say that they are not indicative of their core operations, because these items are not necessarily non-recurring. These items are not non-operating because if they were part of non-operating, then they would be classified as non-recurring; since they are not necessarily non-recurring, they are more closely linked to their normal operations.
g. The reason why Other income (expense), net is classified as nonoperating and Special items, net is classified as operating is because these two are connected with nonoperating and operating. The Other income (expense), net comes from the sale of nonoperating assets (Rockies baseball team), and gains/losses from trading foreign currency. These two items are both not related to Molson Coors

operating activities (selling alcohol). The items in Special items, net are all related to Molson Coors's operations.

h.
    i. The Comprehensive Income in 2013 $760.2. The net income in 2013 is only $567.3, $192.9 below the comprehensive income.
    ii. The differences between Comprehensive Income and Net Income are the inclusions of: foreign currency, derivative instruments, pensions, amortization of net prior service, and unconsolidated subsidiaries. These items are all recurring, since they have happened the past three years, and they are all nonoperating, since they are not linked to the core operations of Molson Coors.

ANALYSIS

i. The non-persistent items on the income statement are Special items, net, Other income (expense), net, and income from discontinued operations. The special items are not necessarily non-recurring items, meaning that they have a chance to occur again, but there is no for-sure chance that they will continue to persist. Also, there amounts are not able to be predicted. Some of the other income, net is persistent. The foreign currency trading will most likely continue since it has been the past few years, but items like the selling of nonoperating assets (Rockies baseball team), are not going to persist. These amounts are not easily predicted (currency based on an always-changing market).

j.
    i. 12.8%
    ii. 12.8%

k. $723.44

l.
    i. The Special items, Equity income, and Other income are non-operating income. The Special items are non-operating since they are the sale of non-operating assets and trades in foreign currency, both not heavily related to the sale of alcohol. The Equity income is also non-operating since it is the income from the investment of MillerCoors; again, not related to the sale of alcohol.
    ii. 2012: $277.98; 2013: $422.58
    iii. 2012: $165.11; 2013: $144.72

m.
    i. The assets that are non-operating are the Affiliates, investments in MillerCoors, and the Notes Receivable accounts. The Affiliates account is non-operating since the subsidiaries of Molson Coors most likely are not involved with Molson's main operations. The Investments account is also non-operating, since the investment in MillerCoors is not linked to their main operations, sale of alcohol. Lastly, the Notes Receivable account is

non-operating because as a merchandiser, you are not making any big-time loans to other companies to continue your normal operations. To be classified as a notes receivable is almost like the investment in MillerCoors; a large amount of money being given to collect income later, aka interest. The Derivative heading instruments (both current and non-current) liability accounts is non-operating since the manipulation of derivatives is not related to their core operations.

ii. Assets: 2012-$13,701.9; 2013-$13,019.2
iii. Liabilities: 2012-$7,992.4; 2013-$6,836.4

n. 2012: .012; 2013: .011
o. Operating Profit Margin: 2012-.042; 2013-.034
Operating Asset Turnover: 2012-.286; 2013-.323
p. .056; Compared to part n, the RNOA with persistent income is higher than with the operating income. The RNOA with persistent income is better for predicting future profitability because the company can make profit from both operating and non-operating operations, but the revenue that they will make in future periods will be mostly based on the persistent income, as in the income that they will be making again period, after period, after period.

APPENDIX

Figure 2-1: Persistent Income

Peristent Income	
Sales	$ 5,999.60
Excise taxes	$ (1,793.50)
Net sales	$ 4,206.10
Costs of goods sold	$ (2,545.60)
Gross profit	$ 1,660.50
Marketing, general and administrative expenses	$ (1,193.80)
Equity income	$ 539.00
Operating income	$ 1,005.70
Other income	
Interest expense	$ (183.80)
Interest income	$ 13.70
Income from operations before taxes	$ 835.60
Income tax expense	$ (106.96)
Net income after taxes	$ 728.64
Less: non-controlling interests	$ (5.20)
Net Income	**$ 723.44**

Figure 2-2: Total after-tax amount of non-operating items

Total after-tax amount of non-operating items		
Non-operating items	**2013**	**2012**
Special items	$ (200.00)	$ (81.40)
Equity income	$ 539.00	$ 510.90
Less: Tax effects	$ 64.68	$ (61.31)
Other income	$ 18.90	$ (90.30)
Total after-tax amount of non-operating items	**$ 422.58**	**$ 277.89**

Figure 2-3: Net Operating Profit, after tax

Net Operating Profit, after tax		
	2013	**2012**
Net income	$ 567.30	$ 443.00
Less: Non-operating items, after tax	$ (422.58)	$ (277.89)
Net Operating Profit, after tax	**$ 144.72**	**$ 165.11**

Figure 2-4: Net Operating Assets

Net Operating Assets		
	2013	**2012**
Total Assets	$15,580.10	$16,212.20
Affiliates	$ (30.80)	$ (52.20)
Investment in MillerCoors	$ (2,506.50)	$ (2,431.80)
Notes Recievable	$ (23.60)	$ (26.30)
Net Operating Assets	**$13,019.20**	**$13,701.90**

Figure 2-5: Net Operating Liabilities

Net Operating Liabilities		
	2013	**2012**
Total Liabilities	$ 6,913.30	$ 8,220.60
Derivative hedging instruments, current	$ (73.90)	$ (6.00)
Derivative hedging instruments, non-current	$ (3.00)	$ (222.20)
Net Operating Liabilities	**$ 6,836.40**	**$ 7,992.40**

Figure 2-6: Return on Net Operating Assets

Return on Net Operating Assets		
	2013	**2012**
Net operating profit, after taxes	$ 144.72	$ 165.11
Net operating assets	$13,019.20	$13,701.90
Return on Net Operating Assets	**0.01111589**	**0.01205015**

Figure 2-7: Operating Profit Margin

Operating Profit Margin		
	2013	**2012**
Net operating proft, after taxes	$ 144.72	$ 165.11
Net sales	$ 4,206.10	$ 3,916.50
Operating Profit Margin	**0.03440717**	**0.04215754**

Figure 2-8: Operating Asset Turnover

Operating Asset Turnover		
	2013	**2012**
Net sales	$ 4,206.10	$ 3,916.50
Net operating assets	$13,019.20	$13,701.90
Operating Asset Turnover	**0.32306901**	**0.28583627**

Figure 2-9: Return on Net Operating Assets

Return on Net Operating Assets (using persistent income)	
	2013
Net persistent profit, after taxes	$ 723.44
Net operating assets	$13,019.20
Return on Net Operating Assets	**0.05556716**

Case 3
Golden Enterprises, Inc.

Statement of Cash Flows

Analysis

a. The statement of cash flows provides information about the cash receipts and cash payments of an entity during a period. It provides important additional information not captured in the income statement and the balance sheet. It is different from an income statement because while the income statement provides the net income from the whole operations, the statement of cash flows provides the net cash flows from the whole operations.
b. The two different methods of preparing a statement of cash flows are the indirect and direct methods. Golden Enterprises uses the indirect method because they adjust the net income in order to convert it to a cash basis. Most companies prefer this method because not only is it easier to prepare than the direct method, but FASB requires companies that use the direct method to make a reconciliation of net income, which is essentially the indirect method. So instead of doing the direct method, which requires use of the indirect, most companies will choose to just do the indirect method.
c. The three sections of the statement of cash flows are: operating, investing, and financing.
d. The operating section is generally cash flows related to the calculation of net income. The adjustments in the operating section are based largely on the current assets and liabilities sections of the balance sheet. The investing section is generally cash flows related to noncurrent assets (with exception of short-term investment). The financing section is generally cash flows related to noncurrent liabilities and equity (with exception of short-term notes payable and dividends payable).
e. Cash equivalents are highly liquid assets. They are readily convertible into cash, such as money mark holdings, short-term government bonds, and commercial paper.
f. Net income is the first item on the statement of cash flows because it is adjusted to the cash basis from the accrual basic (the accrual basic is what the company uses for its daily operations), with the final total being the cash basic amount of cash.

g. Figure 3-1: Statement of Cash Flows

Goldenwood Enterprises	
Statement of Cash Flows	
Cash Flows from Operating Activities	
Net Income	**1,134,037.00**
Adjustments to reconcile net income to net cash provided by operatingg activities	
Depreciation	3,538,740.00
Deferred income taxes	185,939.00
Gain on sale of porperty and equipment	(61,040.00)
Changes in receivables-net	106,367.00
Changes in inventories	200,985.00
Changes in prepaid expenses	200,137.00
Changes in cash surrender value of insurance	62,906.00
Changes in other assets - others	(191,298.00)
Changes in accounts payable	(1,216,399.00)
Changes in accrued expenses	954,938.00
Changes in salary continuation plan	(49,774.00)
Changes in accrued income taxes	59,894.00
Net cash provides by operating activities	**4,925,432.00**
Cash Flows from Investing Activities	
Purchase of property, plant, and equipment	(4,149,678.00)
Proceed from sale of property, plant, and equipment	74,514.00
Net cash used in investing activities	**(4,075,164.00)**
Cash Flows from Financing Activities	
Debt proceeds	38,361,200.00
Debt repayments	(38,287,529.00)
Changes in checks outstanding in excess of bank balances	(267,502.00)
Purchase of treasury stock	(6,860.00)
Cash dividends paid	(1,467,879.00)
Net cash (used in) provided by financing activities	(1,668,570.00)
Net decrease in cash and cash equivalents	**(818,302.00)**
Cash and cash equivalents at beginning of year	**1,893,816.00**
Cash and cash equivalents at end of year	**1,075,514.00**

h. Depreciation expense does not actually generate cash flows for Golden Enterprises. We take out depreciation and amortization over the course of the operating period to apply cost recognition principles, but in reality we are not losing money from our operating activities, so we add the amount back into net cash flows.
i. Golden Enterprises has a big problem with raising cash and cash equivalents. Both years, their cash and cash equivalents have decreased by about 50%. In terms of profitability, their income has remained positive both years, but for year 2013, the net income was almost half of what it was in 2012. Golden Enterprises is in need of help for creating more cash flows and increasing their net income.
j. Golden Enterprises has been decreasing it ending cash and cash equivalents the past couple years. In both years, cash have decreased about $800,000 from the beginning of the period to the end of the period.
k. Golden Enterprises does not have enough cash and cash equivalents laying around in order to pay up front the $5,000,000 expected for purchasing PPE. They will be forced to take out loans and other types of liabilities (maybe through equity) in order to raise enough capital to pay for these expenditures.

Case 4
Pearson PLC

Accounts Receivable

Analysis

a. Account receivables are generally oral promises to pay for goods and services sold. There are notes, trade, and nontrade receivables as well.
b. Notes receivables are written promises to pay on a specified future date. Note receivables also tend to be more long-term than accounts, lasting more than a year or an operating period, whichever is longer.
c. A contra account is a general ledger account which is intended to have its balance be the opposite of the normal balance for that account classification. The two contra accounts that are associated with Pearson's trade receivables are the provision for bad and doubtful debts and provision for sales returns. The provision for bad and doubtful debts is the estimated amount of bad debt that will arise from accounts receivable that have been issued but not yet collected. The provision for sales returns reports merchandise returned by a customer, and the allowances granted to a customer because the seller shipped improper or defective merchandise. Managers will consider historical data, such as previous periods' amounts for these accounts, industry standards, and the current market environment.
d. The percentage-of-sales procedure, also called the income statement approach, is estimated by taking a percentage times net credit sales on account of the period. Then, the ending balance in the provision account is done by increasing the current balance by the amount of bad and doubtful debt expense. The aging-of-accounts procedure, also called the balance sheet approach, is estimated by multiplying a percentage times ending accounts receivable. Then, bad and doubtful debt expense is the difference between the required ending balance and the existing balance in the provision account. I think that the aging-of-accounts procedure is a more accurate estimate of net accounts receivable because the number is directly the ending balance, compared to the other method where the number is the amount needed to get to the ending balance.
e. Even though some customers can be deemed risky to collect from, it is better to extend credit and make sales because it represents what the true amount of demand is for your company. Selling on credit is always riskier than cash, since you are being forced to rely on that person paying. Factors such as the history of the buyer, the financial stability of the buyer, and the overall current market are some factors that managers have to consider when extending credit.

f. The line items that reconcile the change in the provision for bad and doubtful debts are the exchange differences, income statement movements, utilised, and acquisition through business combination. The income statement movements are the amounts estimated that are uncollectable, and the utilised is the amount written-off.

1) Bad and Doubtful Debt Expense (I/S) £26
Provision for Bad and Doubtful Debts (B/S) £26
2) Provision for Bad and Doubtful Debts (B/S) £20
Accounts Receivable (I/S) £20

The provision for bad and doubtful debts, on the income statement, is within the bad and doubtful debts expense. **Figure 4-1: Provision for Bad and Doubtful Debts**

Provision for Bad and Doubtful Debts			
		£ 72.00	
	£ 5.00		
		£ 26.00	
	£ 20.00		
		£ 3.00	
		£ 76.00	

g.

1) Sales Returns and Allowances (I/S) £425
Provision for Sales Returns (B/S) £425
2) Provision for Sales Returns (B/S) £443
Accounts Receivable (I/S) £443

The estimated sales returns appears as a contra account to Sales Returns and Allowances. **Figure 4-2: Provision for Sales Returns**

Provision for Sales Returns			
		£ 372.00	
		£ 425.00	
	£ 443.00		
		£ 354.00	

h.

1) Accounts Receivable (B/S) £5,624
   Sales (I/S) £5,624
2) Cash (B/S) £7,180
   Accounts Receivable (B/S) £7,180

Gross Trade Receivables			
	£1,030.00		
	£5,624.00		
		£ 20.00	
		£ 443.00	
		£7,180.00	
	£ 989.00		

Figure 4-3: Gross Trade Receivables

i.

The difference between the provision for bad and doubtful debts of £76, and the £74.19 by using the method above, are close enough to be adequate for an auditor. Other than this aging accounts method, there are many other factors that have to be taken into consideration. These other factors, such as historical data and industry standards, can change the amount.

	Trade receivables balance	Estimated % uncollectible	Accounts estimated uncollectible
Within due date	£ 1,096.00	2%	£ 21.92
Up to three months past due date	£ 228.00	4%	£ 9.12
Three to six months past due date	£ 51.00	25%	£ 12.75
Six to nine months past due date	£ 20.00	50%	£ 10.00
Nine to 12 months past due date	£ 4.00	60%	£ 2.40
More than 12 months past due date	£ 20.00	90%	£ 18.00
Total	**£ 1,419.00**		**£ 74.19**

Figure 4-4: Aging Accounts Receivable

j.

The trend from 2008 to 2009 shows that Pearson is able to collect its receivables faster than before. The accounts receivable turnover ratio has increased and the average collection period has decreased. Both of these measures indicate that Pearson is collecting their receivables faster than in 2008. Possible reasons could be new policies Pearson has put into place to collect their receivables, more trust with customers, and a more stable market than the previous year.

	2009	2008
Credit sales, net	£5,624.00	£4,811.00
Average gross trade receivables	£1,313.00	£1,216.50
Accounts receivable turnover	4.28	3.95
Average collection period	85.21	92.29

Figure 4-5: Credit Sales

k. Pearson's average collection period for 2009 is about 6 days lagging behind McGraw Hill Publishing, but with its change from 92 days to 85 days in one year, it is definitely possible to catch up to McGraw. Pearson can further reduce its average collection period by enforcing stricter collection policies, building more trust with their customers, and shortening bank processing times. Stricter policies will force customers to pay within a shorter period. Building trust with their customers will give the customers more incentive to pay earlier to keep their strong relationship. Setting up a direct deposit with their customers and the bank will allow their customers to directly deposit their payments to Pearson's bank account, instead of shipping them the check and then Pearson having to deposit it.

Case 5
Graphic Apparel Corporation

Inventory

Analysis

1.
    a. GAC was owned by the owner that Nicki used to work for, but he transferred ownership to Nicki due to falling ill. Nick had developed a strong relationship with him during her time working there, and he knew he could trust her to do well with the company.
    b. The only user for GAC's financial statements was the Internal Revenue Service (IRS), but now the bank also is a user for their financial statements, but does not require them at all times.
    c. The bank only requires GAC's financial statements if GAC breaks their loan agreement. The loan agreement covenant requires a minimum current ratio of 1.0. If the current ratio goes over, then the bank will require GAC to prepare for them their financial statements.
2.
    a. Nicki prides herself in that she is able to design more modern, more edgy designs for her shirts. She believes that these designs will allow her to increase her customer base. These designs did indeed get her new customers, but also put off some of the more conservative, long-time customers.
    b. The majority of GAC's customer base are the long-time conservative retailers.
    c. Due to Nicki's re-design, some of the conservative retailers cut back their orders for the 2014 season. Even though these customers pulled back orders, there was not a drop in orders due to Nicki's new designs attracting new customers. These new customers are start-up clothing stores that are excited by Nicki's new designs. The only drawback to these new customers is that Nicki is worried that she will have difficulty collecting all of her payments from them.
    d. GAC's warehouse roof was leaking in May 2014. The repair cost was minimal, but the water stains to the plain shirts was substantial. Nicki, being the creative designer she is, was able to turn the water stains into part of her new designs. GAC's customers have only returned a few shirts, and there have been no complaints about the water stains, but Nicki noted that dozens of GAC shirts were on the clearance racks in August and were gone in September. These shirts were most likely sold, but there is a chance that the stores removed them due to them not selling. This could have damaging consequences to GAC's future business with these customers.
3. The revenue principle states that revenues are recognized when they are realized or are realizable, and are earned, no matter when cash is received. Therefore,

GAAP indicates that revenue should be recognized when the action (or the expense) that causes the revenue occurs, not when the transaction occurs.

4. GAC requires custom orders to be paid in advance, so the revenue is recorded in advance. This would be appropriate under a cash accounting system.
5. The alternative point in time for reporting revenue from custom orders would be when they are delivered to the customer, similar to how GAC records revenue from graphic design shirt sales. This would be more appropriate since it follows the revenue principle by recording the revenue when the action takes place, and it is in-line with their other revenue recording operations.
6. I believe that recording revenue at the point of delivery is a better method for recording revenue from custom shirts. The main reason behind this is that it follows the revenue recognition principle. It helps allocate the revenue with the action in the same period it takes place. So regardless of when the order was placed, GAC would record revenue at the point of delivery.
7. Switching to the accrual accounting system would create an unearned revenue account for the custom shirt orders, since they are paid in advance. Then, at the point of delivery, the unearned revenue would be reduced and a revenue account would be created. This would not change the current ratio at first, since the cash received offsets the liability created, but afterwards the ratio would be increased since the liability will be reduced. This would affect the financial statements by only increasing revenue when the delivery is made, not when the order is recorded. If the order and delivery take place in different periods, then the revenue would be higher during the period in the delivery, instead of before when it was higher during the period with the order.
8. GAAP requires accounts receivable to be reported at net realizable value – the amount of cash the company estimates will be collected over time.
9. GAC uses the direct write-off method to record bad debts. This method is not acceptable because it fails to achieve the revenue/expense matching principle, and does not establish receivables at NRV. This method is only used when there is no reliable way to estimate bad debts, and when the bad debts are immaterial.
10. As of August 31, 2014, GAC had $10,000 recorded custom sales orders, of which $7,500 had been collected. The other $2,500 has not been collected, but the orders are from teams that Nicki herself is on, so she is not worrying that they will be

Figure 5-1: Days to Sell Inventory

Days to Sell Inventory		
	2014	**2013**
Inventory	24500	9000
Cost of Goods Sold	93000	81000
Days in Year	365	365
Days to Sell Inventory	**96.15591**	**40.55556**

hard to collect. In 2013 at this point in time, GAC only had $100 of custom order to fill. GAC has a lot more responsibility to collect sales this year since the amounts are more material than they were in 2013. Also, the accounts receivable collection period increase from 33 days in 2013 to about 50 days in 2014. This increase shows that the accounts receivable are taking longer to collect than before. Since it is taking longer, using an allowance account rather than directly writing-off helps even more to record the revenues and expenses in the same period.

11. The alternative method that GAC could use is the allowance method. This method is preferred since it achieves the revenue/expense recognition principle, as well as stating receivables at NRV. This method would be better for GAC since, unlike previous years, they have a large amount of sales orders, from custom shirts as well as graphic design shirt sales. The custom shirts could continue to be used with the direct write-off method, since Nicki does not think that these payment will fall through, but for the graphic design shirt sales, switching to the allowance method would be preferred. Because of Nicki's new designs, she acquired new customers. These new customers are mostly start-ups, and Nicki feels that she might have trouble collecting $3,000 of sales. By using the allowance method, Nicki can estimate her allowance for bad debts, in this case $3,000. This will allow her to follow the revenue principle and state her receivables at NRV.
12. I believe that GAC should go with the allowance method. Not only does it fulfill the revenue principle and states the receivables at NRV, but the bad debts are easily estimated and can simply be placed in the allowance for doubtful accounts account. If the receivables are collected, then they are simply recorded back into accounts receivable and into revenue (taken out of allowance). For GAC, this would simplify the estimating of bad debts and the writing-off bad debts processes.
13. The direct write-off method only records an expense and a loss of assets when the bad debts are written off. Using the allowance method creates a contra-asset account and records an expense before the accounts are written off. The current ratio may change depending on the estimation of bad debts. If the bad debts are estimated to be high, then the current ratio will be lower. If the bad debts are estimated to be low, then the current ratio will not be as low, but will still be lower than how it would originally be. Unless the estimation is zero, then the receivables account will always be listed lower (at NRV) than before. This affects the financial statements by actually reporting receivables at net realizable value, therefore decreasing them.
14. GAC reports sales returns in the month that goods are returned by retail customers. This method is acceptable when the sales returns are not easily able to be estimated, or the returns will be immaterial.
15. Nicki noticed that one of the retailers holding her graphic design shirts had them

on the clearance rack, and then didn't have them in the store at all. This caused Nicki to worry, and she estimated that the rest of her shirts in retail stores have a selling price of $15,000. This amount of possible returns is far greater than any previous year's sales returns.

16. GAAP recommends to make a sales returns and allowances allowance account. This is similar to how GAAP recommends to record bad debts, by estimating the amount of probable sales returns, then putting that amount into an allowance account.
17. GAC should consider this alternative because of the huge amount of possible sales returns that can happen from this year's sales. The sales returns are material to the key external user because it shows the quality of the product that GAC is producing, plus how happy they make their customers. A company with a large sales return balance can tell external users that the next few periods' sales could be lower because of dissatisfaction from the customers.
18. I believe that estimating an allowance for sales returns is the better option because it allows for keeping track of how much you think the sales returns are going to be. This amount can very examined every year to determine what strategies increase or decrease this number.
19. This change in methods would decrease net income because net sales would be at a lower value. This would not affect the current ratio because the allowance is a contra-equity accounting, not involved with assets or liabilities.
20. GAAP requires that inventory be recorded at lower of cost or market.
21. GAC has been reporting its inventories of shirts at the lower of cost or market. This is appropriate in most situations because it follows the accounting principle of "conservatism", that is valuing inventory at the lower cost in order not to overstate assets.
22. Some of the inventory has been damaged from the water leakage at the warehouse. Also, the days to sell inventory ratio for 2014 is 96 days, while the 2013 ratio is 41 days. This means that it takes about twice as long for GAC to sell its inventory in 2014 than in 2013. This could mean a number of things, one being the GAC is valuing and selling its inventory at too high of a cost. Even though Nicki initially lost some of her customer base, she was able to pick up new customers that like her edgier designs. But even with this new customer base, her

inventory is taking too long to leave the shelves.

23. The gross profit in 2014 is 48% ($86,950/$179,950). This means that the cost of inventory is 52% of the selling price of inventory. Nicki may need to reduce her gross profit margin in order to increase her sales and reduce idle inventory time. I do not think that Nicki would ever have to reduce her selling price below her cost. Since her gross profit margin is already so high, she can make substantial cuts to the selling price without dipping below the cost price.

Accounts Receivable Collection Period		
	2014	**2013**
Average Accounts Receivable	23750	15500
Annual Sales	179950	170000
Days in Year	365	365
Accounts Receivable Collection Period	**48.1731**	**33.27941**

Figure 5-2: Accounts Receivable Collection Period

24. I believe that GAC should continue to report its inventory at lower of cost or market. They have been using this method, it is GAAP recommended, and it has not caused any major problems for them. The large days in inventory number is not due to how they value their inventory, and since lower of cost or market uses the conservatism principle, valuing it any lower would be difficult. One idea for a different inventory valuation method though is reporting at net realizable value. When goods are damaged or obsolete, as the graphic shirts at the warehouse are, and can only be sold for below purchase prices, they should be recorded at net realizable value. The net realizable value is the estimated selling price less any expense incurred to dispose of the good. The majority of GAC's inventory however is not damage or obsolete, and has been sold to the retailers, so using the net realizable value method would not be recommended.
25. Since I am not recommending changing methods, there is no effect on the statements or ratio.
26. The change in ratio would not be that dramatic compared to what it is currently. Currently, the ratio increased from .83 to 1.35 from 2013 to 2014, so the initial changes Nicki made seem to be helping her keep the covenant with the bank. The revenue principle change will increase the current ratio because the unearned service revenue will be erased with the cash left over. The allowance methods for

Current Ratio		
	2014	**2013**
Current Assets	61000	27000
Current Liabilities	45180	31700
Current Ratio	**1.350155**	**0.851735**

Figure 5-3: Current Ratio

bad debts will decrease the ratio, since the accounts receivable account will be lower since it will be stated at NRV. The sales returns allowance method will not affect the current ratio, since sales does not factor into assets or liabilities.

27. I do not think Nicki will have to contribute more equity to GAC to keep its current ratio of 1. Since the ratio in 2014 was 1.35, and the effects of the recommendations on the current ratio are not drastic and may even balance out (positive and negative effects can cancel), GAC' current ratio can stay above 1.
28. The next steps that I would recommend Nicki do are implementing the three changes in methods that I have gone over in this case: revenue principle, allowance for bad debts, and sales return allowance. Nicki is a smart and talented designer, and she is learning how to run a business. These changes will help Nicki to continue making GAC into a well-known graphic shirt designer.

Case 6
Planes and Garbage

Depreciation

PLANES

1. **Table 6-1: Gain (Loss) on Sales**

TABLE 1			
	Northwest	**Delta**	**United**
Book Value January 1, 2005	75	75	75
Residual	3.75	3.75	3.75
Depreciable amount	71.25	71.25	71.25
Useful life	20 years	25 years	14.5 years
Annual Depreciation	3.5625	2.85	4.91
Accumulated Depreciation at December 31, 2008	14.25	11.4	19.66
Book Valyue at December 31, 2008	60.75	63.6	55.34
Sale Price I	55	60	65
Gan (Loss) on Sale I	-5.75	-3.6	9.66
Sale Price II	60	60	60
Gain (Loss) on Sale II	-0.75	-3.6	4.66

2. Some explanations for ways these three companies can estimate different useful lives for the same plane are: their past experience with the same or similar plane, estimates from their engineering team, standard industry practices, statistical analysis, and judgmental estimates.
3. I believe that the first sales price is more realistic. Each company has a different sales team, different relationships with their customers, and different abilities to negotiate prices. Although each company has the same plane, it is more likely that each company sells it for a different price.

GARBAGE

1. Waste Management's high-ranking officers were engaged in a systematic scheme to falsify Waste Management's earnings and other measures of financial performance.
2. They increased the salvage values and useful lives of their trucks over their lifetime. So the more the trucks were used, the higher their value increased.
3. They manipulated the financial reports in order to meet predetermined earnings targets and thus retain their executive positions, reap substantial performance-based bonuses and, in certain instances, enhanced retirement benefits.
4. Arthur Andersen was the outside auditor for Waste management. They settled to pay $7 million and be censured under the SEC's rules of practice. Andersen seems to have abided with the SEC's rules of practice, however they eventually committed more accounting malpractices, which lead to the buyout of most of their practices by other firms and loss of reputation.

Case 7
GAAP vs IFRS

Standard Differences

Question 1: In 2007, at the time of the purchase, should Construct record a liability for environmental liabilities? If so, how much?

GAAP
According to ASC 410-30-25-1 (or 450-20-25-2), Construct should only record a liability for environmental liabilities if the information about the liability is made present before the financial statements are made, and if the liability can be reasonably estimated. In this situation, while Construct and BigMix are creating an indemnification provision specifically for potential environmental liabilities, there is no amount that can be reasonably estimated at this moment.

IFRS
According to IAS 37-2c, creating a contingency liability is reliant on having a reliable estimate of the contingency. At this point, there is no estimate of potential liability, only the co-op creation of an indemnification provision. Also, there is no likeliness that there will be a liability coming from this case at this time. Without a probable chance of it happening, then the liability will not be recorded.

Question 2: In 2008, should the company record any liability due to BigMix filing for Chapter 11? If so, how much?

GAAP
Since the potential liability resulting from the bankruptcy is still able to be reasonably estimated, then there will be no recording of any liability due to BigMix filing for Chapter 11 (ASC 450-20-05-2b).

IFRS
Construct can record a liability due to BigMix filing for Chapter 11 because in the event of a bankruptcy, and the contributor (to the indemnification provision) can only continue to make insufficient contributions, then this obligation is a contingent liability. However, creating the liability is reliant on additional contributions being made; without additional contributions, then the liability cannot be established (IAS 37-10).

Question 3: In 2009, should the company record any liability for the potential environmental liability? If so, how much?

GAAP
According to ASC 450-20-05-10, pending or threatened litigation counts as a loss contingency. Normally, we would select the lowest value in a range of possible amounts, but in this case they have already estimated the potential liability to be $250,000 (including legal fees) (ASC 450-20-30-1).

IFRS
Looking again at IAS 37-2c, if the liability can be reasonably estimated, and it is more likely than not to happen, then the liability will be recorded at the estimated amount. IFRS, instead of calling for the lower value in a range of amounts, chooses to use the midpoint of the range. In this case there is no range, so they will record the liability of $250,000 (IAS 37-39)

Question 4: In 2010, should the company record any liability for the potential environmental remediation? If so, how much?

GAAP
Construct should record both the legal fees and the cost of the remediation because Construct is responsible for participating in a remediation process, and that the outcome of the process will be unfavorable to Construct. Construct understands the significance of this RI/FS and is aware of the negative effects that it brings. 25-11 then states that the legal fees and the cost of the remediation are included in the liability (ASC 410-30-25-4).

IFRS
IAS 37 continues to state that the environment remediation will be added to the contingent liability because it has a more than likely chance of occurring and the value can be reasonably estimated.

Question 5: In 2011, should the company record any additional liability for the potential environmental remediation?

GAAP
The additional liability for the potential environmental remediation will be added to the liability amount. The plan of $1.5 million will be added to the liability because ASC 410-30-35 states that the costs associated with remediation of a site ultimately will be assigned and allocated among the various potentially responsible parties. However, in this case the other parties have more or less left the game, and it is solely Construct that has to clean up this mess. The liability will include these amounts for now, but with time BigMix and its shareholders can be made to allocate to the liability as well.

IFRS
Compared with GAAP, IFRS works more as laying down a broad principle and then letting individual situations apply that principle. This can be seen in that most of these answers come from IAS 37 (contingencies). The additional liability for the potential environmental remediation will indeed be added to the contingent liability.

Question 6: In 2012, should the company record any gain contingency/contingent asset for the potential settlement?

GAAP
A contingency that might result in a gain should not be reflected in the financial statements because to do so might be to recognize revenue before its realization. In this case, regardless of the fact that Construct's attorneys believe there is a 75% chance of obtaining a $1 million settlement, this gain will not be recognized until it is received. Construct will have to disclose the gain contingency in its financial statements, but it will have to be weary not to avoid misleading the likelihood of realization (ASC 450-30-25-1).

IFRS
The contingent asset will also not be recorded, in order to prevent the recognition of potential income that would have otherwise not be realised. However, if an inflow of economic benefits is probable, then the contingent asset has to be disclosed. In this case, Construct will then disclose the probable $1 million settlement, but will not record it. The contingency will have to be monitored to ensure that the amount and potential realization are accurate (IAS 37-31).

Case 8
Rite Aid Corporation

Long-Term
Debt

CONCEPTS

a.

i. Rite Aid's secured debt is backed and tied to assets. Rite Aid's unsecured debt is valued solely on its credit-worthiness. Rite Aid's distinguishes between these two types of debt in order to provide more useful information to external users of their financial statements, such as investors, lenders, etc.

ii. "Guaranteed" debt is debt where one party assumes the debt obligation if the borrower cannot pay the debt. All of Rite Aid's wholly-owned subsidiaries guarantee Rite Aid's unsecured debt.

iii. senior – means the debt takes priority over other unsecured debt
fixed-rate – the interest rate remains constant over the life of the debt
convertible – type of bond that allows the bond to be converted into common stock

iv. In order to finance the operations of the firm, companies need to take in varying amounts of debt. Pinning all of the debt on all of the assets purchases is risky. By diversifying debt and allowing debt to more closely resemble the asset linked with it, companies are better equipped to succeed in the market.

PROCESS

b.

Total Debt	$6,370,899
Debt due within coming fiscal year	$51,502
Long-Term Debt	$6,185,633
Lease Financing Obligations	$133,764
Total Debt	**$6,370,899**

c.

i. The face value, or principal, of these notes is $500,000. The notes were issues at par because there was no change in value from 2009 to 2010.

ii.

Cash	$500,000	
Bonds Payable		$500,000

iii.

Interest Expense	$37,500	
Cash		$37,500

iv.

Bonds Payable	$500,000	
Cash		$500,000

d.

i. The face value of the notes is $410,000. The carrying value on February 27, 2010 is $405,951. These values differ because these the stated rate was higher than the market rate, therefore the notes were sold at a discount.

ii. The interest Rite Aid payed on these notes during the fiscal 2009 was $38,437.50.

iii. The total amount of interest expense recorded by Rite Aid on these notes for the year ended February 27, 2010 is $39,142.50.

iv. Interest Expense $39,142.50
Cash $38,437.50
Discount on Notes Payable $750

v. The total rate of interest recorded for fiscal 2009 on these notes is 9.67%.

e.

i. Cash $402,620
Bonds Payable $402,620

ii. The effective annual rate of interest on these notes issued was 10.1212%.

iii. Figure 8-1: Amortization Schedule – Effective Interest Method

Amortization Schedule - Effective Interest Method					
Date	*Interest Payment*	*Interest Expense*	*Bond Discount Amortization*	*Net Book Value of Debt*	*Effective Interest Rate*
30-Jun-09				$ 402,620.00	10.12%
30-Jun-10	$ 39,975.00	$ 40,749.98	$ 774.98	$ 403,394.98	10.12%
30-Jun-11	$ 39,975.00	$ 40,828.41	$ 853.41	$ 404,248.39	10.12%
30-Jun-12	$ 39,975.00	$ 40,914.79	$ 939.79	$ 405,188.18	10.12%
30-Jun-13	$ 39,975.00	$ 41,009.91	$ 1,034.91	$ 406,223.08	10.12%
30-Jun-14	$ 39,975.00	$ 41,114.65	$ 1,139.65	$ 407,362.73	10.12%
30-Jun-15	$ 39,975.00	$ 41,230.00	$ 1,255.00	$ 408,617.73	10.12%
30-Jun-16	$ 39,975.00	$ 41,357.02	$ 1,382.02	$ 409,999.75	10.12%

iv. Interest Exp $27,167
Cash $26,650
Bonds Payable $517

v. The net book value of the notes at February 27, 2010 is $403,137.

vi. Figure 8-2: Amortization Schedule – Straight-line Method

Amortization Schedule - Straight-line Method					
Date	*Interest Payment*	*Interest Expense*	*Bond Discount Amortization*	*Net Book Value of Debt*	*Straight-Line Interest Rate*
30-Jun-09				$ 402,620.00	
30-Jun-10	$ 39,975.00	$ 41,029.00	$ 1,054.00	$ 403,674.00	10.16%
30-Jun-11	$ 39,975.00	$ 41,029.00	$ 1,054.00	$ 404,728.00	10.14%
30-Jun-12	$ 39,975.00	$ 41,029.00	$ 1,054.00	$ 405,782.00	10.11%
30-Jun-13	$ 39,975.00	$ 41,029.00	$ 1,054.00	$ 406,836.00	10.08%
30-Jun-14	$ 39,975.00	$ 41,029.00	$ 1,054.00	$ 407,890.00	10.06%
30-Jun-15	$ 39,975.00	$ 41,029.00	$ 1,054.00	$ 408,944.00	10.03%
30-Jun-16	$ 39,975.00	$ 41,031.00	$ 1,056.00	$ 410,000.00	10.01%

vii.

The effective interest method pays less interest expense in the early interest payments, but pays more interest expense in the later interest payments. The differences are relatively immaterial, but the differences are the greatest in the interest payments near the first and last interest payment.

f.

i. Notes Payable $810,000

Cash $797,769

Gain on Retirement of Debt $3,750

ii. Rite Aid did not have to pay the face value to repurchase these notes

Interest Method Comparison		
Effective	*Straight-Line*	*Difference*
$40,750.00	$ 41,029.00	$ (279.00)
$40,828.00	$ 41,029.00	$ (201.00)
$40,915.00	$ 41,029.00	$ (114.00)
$41,010.00	$ 41,029.00	$ (19.00)
$41,115.00	$ 41,029.00	$ 86.00
$41,230.00	$ 41,029.00	$ 201.00
$41,357.00	$ 41,029.00	$ 328.00

Figure 8-3: Interest Method Comparison

because the note had yet to reach their maturity date, so their carrying value was below their face value.

iii. The market rate was higher than both the 9.5% coupon rate and the effective rate.

g. Firms issue convertible bonds to lower their interest rates and attract more investors. Investors buy convertible notes in order to gain an equity position within the firm. If Rite Aid converted these notes, then the liability will be reduced and the equity will be increased on Rite Aid's balance sheet.

h.

i. Figure 8-4: Ratio Analysis

Analysis				
Ratio	*Definition*	*Industry Average*	*Rite Aid FY2009*	*Rite Aid FY2008*
Common-size debt	Total liabilities/Total assets	43.83%	120.79%	114.41%
Common-size interest expense	Interest expense/Net sales	0.35%	2.00%	1.82%
Debt to assets	Total long-term debt/Total assets	14.41%	71.28%	78.50%
Long-term debt equity	Total long-term debt/Total shareholders' equity	0.26%	-494.80%	-377.60%
Proportion of long-term debt due in one year	Long-term debt due in one year/Total long-term debt	6.11%	0.81%	0.69%
Times-interest-earned (Interest coverage)	(Pretax income+interest expense)/Interest expense	33.44%	6.95%	-6094.00%

ii. For almost all of these ratios, Rite Aid is very off when compared to the Industry Average.

iii. As a credit analyst, I am very worried about Rite Aid's ability to meet its long-term commitments as they come due. Rite Aid's debt to asset ratio is more than triple the industry average. They have been running a deficit for total shareholders' equity for the past three years.

iv. The operating cash flow ratio would be an additional measure to help evaluate Rite Aid's ability to meet its long-term commitments as they come due. This ratio shows how Rite Aid can use its liquid cash to pay of its yearly debts.

i. I would use the CCC score to describe Rite Aid. The CCC score states "Currently vulnerable and depended on favorable business, financial and economic conditions to meet financial commitments." This description suits Rite Aid because their financials show how vulnerable Rite Aid is to not being able to pay of its debt as they mature. Also, Rite Aid is doing very well in against its competitors in the industry as far as sales and market penetration are concerned, but if they did not enjoy being at the top of the industry, then they would have a very hard time competing in the market.

Calculations

c. iii.

$500,000*.75%=$37,500

d. ii.

Int Payment=$410k*9.375%=$38,437.50

iii.

$405,951-$405,246=$705
$38,437.50+$705=$349,142.50

v.

$39,187.50/$405,246=9.67%

e. i.

$410,000*98.2%=$402,620

iv.

$39,975*(8/12)=$26,650
$402,620*10.1212*(8/12)=$27,167
$27,167-$26,680=$517

v.

$402,620+$517=$403,137

vi.

$410,000-$402,620=$7,380
$7,380/7=$1,054

h.

Common-size debt

2008
$9,526,195/$8,326,540=1.1441
2009
$9,723,462/$8,049,911=1.2079

Common-size interest expense

2008
$477,627/$26,289,269=.018168
2009
$515,763/$25,669,117=.0200

Debt to Assets

2008
$5,935,397/$8,326,540=.7128
2009
$6,319,397/$8,049,911=.7850

Long-term debt equity

2008
$5,935,397/($1,199,652)=-4.948
2009
$6,319,397/($1,673,551)=-3.776

Proportion of long-term debt due in one year

2008
$40,683/$5,935,397=.00685
2009
$51,502/$6,319,397=.00814

Times-interest earned (interest coverage)

2008
(-$29,582,794+$477,627)/$477,627=-60.94
2009
(-$479,918+$515,763)/$515,763=.0695

Case 9
Merk & Co., Inc. and GlaxoSmithKline plc

Shareholders' Equity

Analysis

a.
   i. Merck is authorized to issue 5,400,000,000 common shares.
   ii. At December 31, 2007, Merck has actually issued 2,983,508,675 common shares.
   iii. The value per share is $.01/share. By multiplying the value per share by the total number of shares, we arrive at the dollar value of common stock reported on the balance sheet. $.01/share * 2,983,508,675 shares = $29.8 million
   iv. At December 31, 2007, Merck has 811,005,791 common shares held in treasury.
   v. At December 31, 2007, Merck has 2,172,502,884 common shares outstanding.
   vi. On December 31, 2007, Merck's total market capitalization is $1.25*10^11.

b.
   i. GlaxoSmithKline is authorized to issue 10,000,000,000 ordinary shares.
   ii. At December 31, 2007, GlaxoSmithKline has actually issued 6,012,587,026 ordinary shares.
   iii. At December 31, 2007, there are 5,373,862,962 ordinary shares in free issue.
   iv. At December 31, 2007, 504,194,158 ordinary shares are held in treasury.
   v. On GlaxoSmithKline's balance sheet, the share capital account is a portion of a company's equity that has be obtained by trading ownership in the company to a shareholder for cash. If the par value is less than what is paid for the stock (market price), then the additional capital is placed in the share premium account. Merck calls these types of accounts on their U.S. GAAP balance sheet common stock and additional paid-in-capital.

c. Companies pay dividends on their common or ordinary shares for a few reasons, mostly dealing with the investors. One reason is that investors like the steady income associated with dividends, and are more likely to buy a company's stock if they pay dividends regularly. Investors also see dividends as a sign of a company's strength because if a company pays dividends, then the management must have positive expectations about the future outlook of the company. The increase in demand of a company's stock increase the stock's price as well. Normally, a company's share price will decrease when dividends are paid.

d. Companies repurchase their own shares for a few reasons. Firstly, if a company has extra capital and no future plan to use it, and they want to increase their control over the company, then buying back stock with the unused capital can increase their ability to control the company. Secondly, if their stock price is undervalued, then they can repurchase their own stock, and sell it for a profit

when their stock price is valued at a higher price. Also, a company can increase their earning per share by buying back stock, since they are decreasing the amount of shares outstanding.

e. A single journal entry to summarize Merck's common dividend activity in 2007 is:

Dividends Declared	$3,310.7 million	
Cash		$3,307.3 million
Dividends Payable		$3.4 million

f.

i. A single journal entry to summarize GlaxoSmithKline's ordinary dividends to shareholders in 2007 is:

Dividends Declared	£2,739 million	
Cash		£2,739 million

ii. Compared with Merck, GlaxoSmithKline operates under IFRS, instead of GAAP. Dividends are recorded only when paid, not when declared. GlaxoSmithKline typically pays dividends two quarters after the quarter in which it relates, and one quarter after it is declared. To reconcile dividends to the statement of cash flows, we must examine the cash dividends from the third and fourth quarters of 2006, and the first and second quarters of 2007. The cash dividends (all in millions) from 2006 are: £671 and £785. The cash dividends from 2007 are: £670 and £667. Therefore, £671+£785. +£670+£667=£2,793.

g.

i. The method that Merck uses to account for its treasury stock transactions is called the cost method, which is also the most widely used method. For the repurchase of stock, the entire amount paid is recorded in the treasury stock account. For the resale of treasury stock, we offset the sale price against the treasury stock account, and credit the sales exceeding the repurchase cost to the additional paid-in-capital treasury stock account. However, if the sale price is less than the repurchase cost, then the difference is charged to the additional paid-in-capital treasury stock account, and if there is no balance left in this account, then the rest is charged to retained earnings.

ii. In 2007, on the open market, Merck repurchased 26.5 million common shares.

iii. To buy back its stock during 2007, Merck paid $1,429.70 million in total, and $53.95 per share. The type of cash flow this represents is an outflow.

iv. The reason that Merck does not disclose its treasury stock as an asset is because assets should have probably future economic benefits, while treasury stock simply reduces their common share value.

h.

i. In 2007, on the open market, GlaxoSmithKline repurchased 285,034,000 ordinary shares. Of these shares, 216 million were held in treasury, and 16 million were cancelled.

ii. The company paid, on average $13.09 for each share repurchased during 2007.

iii. The name of the comparable financial statement required under U.S. GAAP is the Statement of Retained Earnings. This is different when compared to GAAP because under GAAP the movements in equity must be recorded under the Statement of Stockholder's Equity. A single journal entry to summarize GlaxoSmithKline's share purchases in 2007 is:

Retained Earnings	£3,750 million	
Cash		£3,750 million

i. The main differences I observed in Merck's dividend-related ratios across the two years is that it seems that 2006 ended up being a better year than 2007. Most of the ratios are higher than they are in 2007, except for the dividend payout, which is attributable to 2006 having a higher net income than in 2007, therefore form a stockholder perspective 2006 might not be more favorable in the dividend payout. There is no main difference between the two companies' dividend-related ratios, solely because all the ratios are different, there is no sole one. Glaxo has a higher number of shares outstanding than does Merck in either year, causing their dividend ratios to vary greatly, expect for the dividends to operating cash flows ratio. This ratio appears to be relevant with Merck's.

	Merck ($)		Glaxo (£)
(in millions)	**2007**	**2006**	**2007**
Dividends paid	3307.3	3322.6	2793
Shares outstanding	2,173	2,168	5,374
Net income	3275.4	4433.8	6134
Total assets	48350.7	44569.8	31003
Operating cash flows	6999.2	6765.2	6161
Year-end stock price	57.61	41.94	97.39
Dividends per share	1.522345505	1.53271626	0.519738
Dividend yield	0.026425022	0.036545452	0.005337
Dividend payout	1.009739268	0.749379765	0.455331
Dividends to total assets	0.068402319	0.074548237	0.090088
Dividends to operating cash flows	0.472525431	0.491131083	0.453335

Figure 9-1: Dividends

j.

i. FMR held 4.75% of Merck's total outstanding shares at the year-end 2007.

ii. FMR would have to purchase 27,096,788 shares on the open market to acquire 6% interest in the company.

	Investment in Merck	$1,540,994,334	
	Cash		$1,540,994,334
iii.	Treasury Stock		$25,683,237,960
	Cash		$25,683,237,960

Case 10
State Street Corporation

Marketable Securities

Analysis

a.

i. Trading securities are debt securities bought and held primarily for sale in the near term to generate income on short-term price differences.

ii. To record $1 of either dividend or interest received from trading securities, a company would debit cash and credit either dividend revenue or interest revenue, depending on the type of cash received.

iii. If the market value of trading securities increased by $1 during the period, then the company would debit Securities Fair Value Adjustment – trading and credit Unrealized Holding Gain/Loss – Income.

b.

i. Securities available-for-sale are debt securities not classified as held-to-maturity or trading securities.

ii. To record $1 of either dividend or interest received from securities available-for-sale, a company would debit cash and credit either dividend revenue or interest revenue, depending on the type of cash received (the same as trading securities).

iii. If the market value of securities available-for-sale increased by $1 during the period, then the company would debit Securities Fair Value Adjustment – available-for-sale and credit Unrealized Holding Gain/Loss – Equity.

c.

i. Securities held-to-maturity are debt securities that the enterprise has the positive intent and ability to hold to maturity. Equity securities cannot be classified as held-to-maturity because equity securities have no maturity date.

ii. If the market value of securities held-to-maturity increased by $1 during the period, then there would be no journal entry to record this change because securities held-to-maturity are recorded at amortized value, not market value.

d.

i. The balance on December 31, 2012 for Trading account assets is $637 million. This amount is also the market value since trading securities are recorded at market value.

ii. If the 2012 unadjusted trial balance listed the trading account assets at $552 million, then the journal entry to adjust this balance to the market value would be:

Securities Fair Value Adjustment – Trading	$85 million	
Unrealized Holding Gain/Loss – Income		$85 million

e.

i. The 2012 year-end balance for investment securities held to maturity is $11,379 million.

ii. The market value of State Street's investment securities held to maturity is $11,661 million.

iii. The amortized cost of State Street's investment securities held to maturity is $11,379 million. "Amortized cost" represents the original cost of the securities amortized over the course of its life using the effective-interest method. The amortized cost is lower than the original cost since it is being reduced every period.

iv. The difference between the fair market value and the amortized cost of these securities represents the increase in the value of these securities. The increase means the average market rate of interest for securities held to maturity has increased over the life of the securities.

f.

i. The 2012 year-end balance for investment securities for sale is $109,682 million. This balance represents the fair market value of these securities.

ii. The amount of net unrealized gains or losses on the available-for-sale securities held by State Street on December 31, 2012 is a $1,119 million gain. It is compromised of a $2,001 million unrealized gain and a $882 million unrealized loss.

iii. The amount of net realized gains and losses for investment securities available for sale in 2012 is $55 million. This amount is an increase to State Street's net income.

g.

i. The journal entry to record the purchase of available-for-sale securities is:

Investment securities available for sale	$60,810 million	
Cash		$60,810 million

ii. The journal entry to record the sale of available-for-sale securities is:

Cash	$5,399 million	
Unrealized Holding Gain/Loss - Equity	$67 million	
Net Realized Holding Gain		$55 million
Investment Securities Available for Sale		$5,411 million

iii. The original cost of the available-for-sale securities sold during 2012 is their book value of $5,411 million, plus their unrealized holding gain/loss of $67 million, $5,478 million.

iv. The amount of net unrealized gains/losses during 2012 for the available-for-sale securities on hand at December 31, 2012 is $1,186 million. To determine that amount, we have to reconcile the unrealized holding gain/loss account ($2,001-$882), then add back in the loss from the sale of

available-for-sale securities ($67) to arrive at $1,186 million. The journal entry to mark the available-for-sale securities portfolio to market value at year end is:

Investment Securities Available for Sale	$67 million	
Securities Fair Value Adjustment – AFS		$67 million

This amount would not affect the statement of cash flows since no cash is being transferred.

h.

i. The year-end balance in State Street's accumulated other comprehensive income gain/loss account for 2012 is a $360 million gain, and for 2011 is a $659 million loss.
ii. The amount of the net change in the "Accumulated other comprehensive income gain/loss" account relating to net unrealized gains/losses on available-for-sale securities during 2012 is a $798 million gain.
iii. The difference between the amounts is likely due to the unrealized holding gain/loss resulting from the sale of available-for-sale securities during 2012.

i. Had State Street classified their available-for-sale securities as trading for 2012, then the unrealized holding gains/losses would have all been under income instead of equity, therefore increasing the income before income tax expense by $798 (without taking into account part g), to $3,564 million. This amount would also be reduced from other comprehensive income, resulting in an other comprehensive income of $221 million. This new other comprehensive income would change the balance of the stockholders' equity account at December 31, 2012 to $438 million (loss).

j.

i. Requiring all marketable securities to be presented at market value is a worse method of accounting because the intention of the marketable securities is what matters most. If the intention of the securities is to be sold quickly, then using the market value would be relevant. However, if the securities were never intended to be sold, then having them recorded at market value gives an unrealistic view on the company's financial statements.
ii. Requiring all marketable securities to be presented at market value can be understandable because intentions can change on a whim. What once was a held-to-maturity security could easily be sold the next day depending on the company's situation. Therefore, since markets are volatile and securities can easily be sold, requiring all marketable securities to be recorded at market value gives a better representation of the company.
iii. If I were the CFO of State Street in 2012, I would have preferred recording ally my securities at market value, since their market values are

higher than their amortized values. However, if I were an investor, I would prefer to have State Street's securities be valued at the correct valuation based on their intentions. This would give me a more accurate view of the company so I could make better decisions.

Case 11
Groupon

Revenue Recognition

Analysis

1. Groupon's business model is selling vouchers for other business's goods/services to customers once a critical number of customers express interest. When the customers redeemed the vouchers with the business, Groupon then remits a portion of the proceeds to the business and retains a remainder. Walmart's business model is selling a variety of products bought wholesale from other retailers. Amazon's business model is selling either self-made products or products from other retailers/individuals. Groupon's business model differs from these two companies because Groupon is actually not selling the product or service stated on the voucher. I like to think of Groupon as similar to a travel agency. Customers use both of these services because they offer the good/service at a lower price than the traditional method of purchasing straight from the business. The profit these kinds of companies make is the difference between the discounted and non-discounted price.

   The risk factors in the MD&A sections on the 10k forms for these companies are both similar and different. All these companies have risks of intense competition and expansion strains. Groupon and Amazon both state having problems maintaining revenue growth. Walmart is currently facing a new threat from retailers such as Dollar General that can expand into more markets due to its smaller store size; they are also pricing their products at a lower price than Walmart. The expansion of the internet over the last decade has presented both risks and opportunities to these companies. It has caused fundamental change in the retail industry, while also creating more opportunity to expand their markets. Since markets and industries are changing at a quicker pace than earlier due to the internet, this causes predicting future performance and future factors listed on financial statements, such as allowances, refunds, bad debts, etc.

2. By examining Amazon's 10k forms from 1997-2010 and specifically looking at revenue, income, and stock price, we can see that Amazon's stock price increased over time due to their increase in revenue. While Amazon did not always have a positive income, the market thought that their revenue growth was more important to their long-term success than their current income, therefore their stock price continued to grow.

   I agree with Amazon focusing more on revenue growth than on income growth, especially in this "new-age economy" where markets and industries experience change more frequently than before. Focusing on revenue growth gives companies more the opportunity to increase their market share as well as more ability to adapt and try new strategies.

Below are three graphs showing Amazon's revenue, income, and stock price change from the years 1997-2010. (The y-axis is in thousands of $; the x-axis numbers 1-14 represent years 1997-2010).

Figure 11-1: Revenue

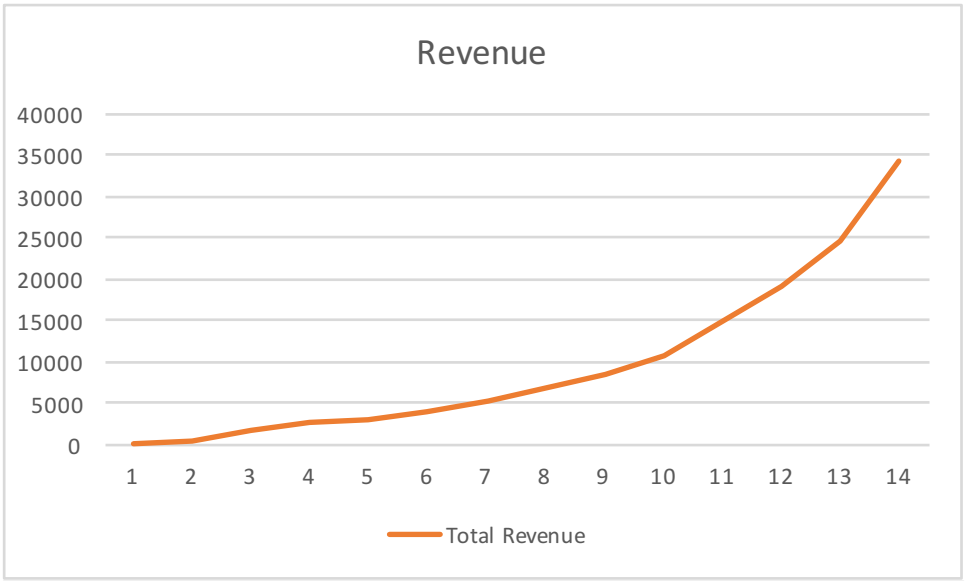

Figure 11-2: Income

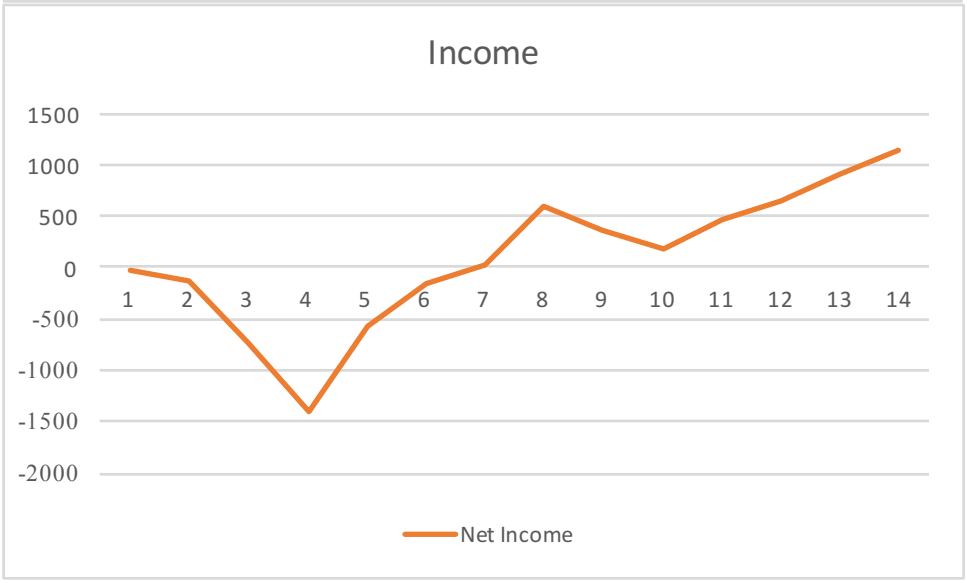

Figure 11-3: Stock Price

3. For both years 2009 and 2010, the gross method's expenses are consistently a lower percentage of total revenue than the net method's. The cost of sales under the gross method is larger than under the net method. The asset turnover ratios are also larger under the gross method than the net method. The net loss under net method is higher for both years. The gross margin percentage under the net method is larger than the gross method. Below is the common size income statement for Groupon in years 2009 and 2010.

Figure 11-4: Income Statement

Groupon Common Size Income Statement				
Account	**2009 Gross**	**2009 Net**	**2010 Gross**	**2010 Net**
Revenue	100.00%	100.00%	100.00%	100.00%
Cost of Sales	64.14%	30.34%	60.75%	10.39%
Gross Margin	35.86%	69.66%	39.25%	89.61%
Marketing Expense	15.13%	33.79%	36.89%	90.86%
Gen and Admin Expense	24.67%	44.14%	32.79%	68.17%
Other Expenses	0.00%	0.00%	28.48%	64.94%
Net Loss	-4.41%	-7.52%	-57.95%	-134.26%
Total Assets *(in millions)*	$1,496.20	$1,496.20	$38,157.00	$38,157.00
Asset Turnover Ratio	2.03%	0.97%	1.87%	0.82%

4.

a. The difference in the original S-1 compared to the amended S-1 is that Groupon switched from using the gross method to using the net method, causing their revenues to decrease. The revenues decreased because they were only recording the net difference between the original price of the good/service and the voucher price that they sold. Under the gross method, they were recording the original price as revenue, causing their revenues to be overstated.
b. In my opinion, Groupon preferred the gross method because their revenues were higher than under the net method. This was obvious due to their not-so-logical correspondents with the SEC, in which they had to eventually switch to the net method since it is what is acceptable under GAAP. It is understandable for Groupon to want larger revenues, since it is still a new company and is trying to appear healthy and growing to investors.
c. Groupon responded with saying it was the primary obligor, therefore able to record the gross amount of the sale because their vouchers gave the customers the ability to purchase the full amount of the good at a discounted price. They argued this was in accordance with ASC 605-45-45.
d. Groupon's argument stating that they were the primary obligor of these transactions was weak because Groupon is not the business that is in the end providing the good/service.

5.

a. The U.S. GAAP requirement for recognizing revenue when right of return exists is that revenue is allowed to be recognized if the amount of returns can be probably estimated. When done, an allowance account is created and the amount of probably returns is added to this account, each time revenue that has a right of return is recorded. The problem with Groupon for the sale of high-ticket items in late 2011 is that these returns were not able to be probably estimated, due to their constant entry into new markets where no previous historical data or other information existed.
b. Even though Groupon's return policy, the "Groupon Promise", is vague and they have failed to accurately predict these kinds of returns in the past, to simply not be able to record revenue for these sales presents an inaccurate representation of the company on their financial statements. I believe that Groupon needs to constantly be improving their prediction models, but as long as it is done in goo-faith, which is hard to ask of a public company, then the revenue should be recorded. Whether this is how the rules and regulations are currently, now that is a different story.

c. One way Groupon could have acted differently is to not record revenue until the voucher is redeemed or becomes unreturnable. This would guarantee the revenue is not recorded incorrectly and could reduce the errors in estimating returns. This would affect their financial statements by decreasing revenues in every year, but it would have also reduced the 2011 return fiasco. This is a tough choice to make for Groupon, since public companies want to appear as good as possible to investors, but also do not want to incur greater risks.

6. This is possible due to the fact that the cash received from did not actually change with the restatement. More revenue was taken out and put into the allowance account, but the cash received from customers was not touched.

   Also, in the operating section of cash flows, while we start out with net income (using the indirect method), that amount is reconciled with adjustments. So different types of accounts, (accounts receivable, accounts payable, etc.) then affect the ending total cash flows from operating activities. The new differences in these accounts after the restatement could cause the ending cash flows to remain the same.

Case 12
ZAGG, Inc.

Deferred
Income Taxes

Analysis

a.

i. Book income, also known as financial income, is a company's pre-tax income. The number in ZAGG's statement of operation that captures this notion for fiscal 2012 is the "income before provision for income taxes", $23,898 thousand. Book income and taxable income vary in that taxable income includes temporary and permanent differences, and loss carrybacks and carryforwards.

b.

i. Permanent tax differences are revenues or expenses that will never be taxable or deductible in any period. One example is a fine levied on a company. This expense cannot be deducted. Therefore, it is a permanent difference between book and taxable income for the period.

ii. Temporary tax differences are revenues or expenses that are recognized in taxable income but not yet in book income. One example is unearned revenue. If a company received rent revenue in advance, then the taxable income would be greater than the book income, since the revenue on the books has not yet be earned and recorded.

iii. The statutory tax rate is the tax rate imposed by the law.

iv. The effective tax rate is the tax rate that the company ends up paying after accounting the tax credits and deductions. This is calculated by taking the income tax expense and dividing by the pre-tax income.

c. Companies report their deferred income taxes as part of their total income expense in order to give a better, more accurate representation of their current financial situation.

d. A deferred tax asset represents the increase in taxes refundable (saved) in future years as a result of deductible temporary differences at the end of the current year. An example of a deferred tax asset is the unearned revenue temporary difference example from earlier. If a company received rent revenue in advance, then the taxable income would be greater than the book income, since the revenue on the books has not yet be earned and recorded.

   A deferred ta liability represents the increase in taxes payable in future years as a result of taxable temporary differences existing at the end of the current year. An example of a deferred tax liability is when the tax method of recording depreciation is at a rate faster than than the book method. If tax is using double-declining compared to book's straight-line method, then the difference between the methods would yield a deferred tax liability.

e. A deferred tax income valuation allowance represents that portion of the deferred tax asset which more likely than not will not be realized. It should be used if there is over a 50% probability that the deferred tax asset will not be realized.

f.

i. The journal entry that ZAAG recorded for the income tax provision in fiscal 2012 is:

Income Tax Expense	$9,393 thousand	
Deferred Tax Asset	$8,293 thousand	
Income Taxes Payable		$17,686 thousand

ii. ZAGG's total deferred tax assets in 2012 is $14,302 thousand. Taking out the $6,300 thousand of 2011's deferred tax assets, 2012's deferred tax assets is $8,002 thousand. In 2012, deferred tax liabilities is $794 thousand; in 2011, deferred tax liabilities is $1,086 thousand; therefore, ZAGG's net deferred tax assets is $292 thousand. Combining the deferred tax assets and deferred tax liabilities of 2012, ZAGG reports the $8,294 thousand in deferred tax assets.

iii. ZAGG's 2012 effective tax rate is 39.30%. The difference in effective and statutory tax rate is due to four factors: non-deductible expenses, domestic production activities deduction, return to provision adjustment, and an increase in valuation allowance.

iv. The $13,508 thousand net deferred tax assets is reported in two sections on ZAGG's balance sheet. $6,912 thousand is reported under current assets and $6,596 is reported under noncurrent assets, both labelled as "deferred income tax assets."

g.

i. As of December 31, 2012, ZAGG's tax system is recognizing a greater expense over time relating to depreciation. We can make the assessment that ZAGG is using some kind of accelerated depreciation method for tax purposes because the difference is resulting in a deferred tax liability, not a deferred tax asset.

ii. Figure 12-1: Deferred income tax liability

Cumulative difference in book and tax depreciation expense
$2,089.47
*
Statutory income tax rate
38.00%
=
Deferred income tax liability relating to property and equipment at 12/31/2012
$794.00

iii. In 2012, the reported balance of property, plant, and equipment is $4,862 thousand. If ZAGG also used the accelerated depreciation method it used for tax for book throughout the assets' lives, then the balance would be decreased by $2,089 thousand, yielding a balance of $2,773 thousand.

h.

i. During the year ended December 31, 2012, ZAGG's book system recognized a greater expense for doubtful accounts than the tax system because the difference resulted in a deferred tax asset. For book purposes, bad debt is allocated when the allowance account is set up; for tax purposes, the bad debt cannot be deducted until it has been recognized through not collecting the debt.

ii. **Figure 12-2: Change in the deferred income tax asset**

Current period difference in book and tax bad debt expense in 2012
$2,684.21
*
Statutory income tax rate
38.00%
=
Change in the deferred income tax asset relating to the allowance for doubtful accounts
$1,020.00

i. The amount of the deferred income tax asset valuation allowance at December 31, 2012 is $713 thousand. ZAGG recorded a full valuation allowance against a deferred tax asset generated by losses on its equity method investment in HzO. Because HzO is a development stage enterprise and given current operations and uncertainty of future profitability, ZAGG's management determined that it is more likely than not that the deferred tax asset will not be realizable.

j. ZAGG'S journal entry related to the net deferred income tax asset is:

Income Tax Asset $1,930 thousand
Deferred Tax Asset $1,930 thousand

k.

i. The amount of the impairment of goodwill that resulted from the analysis in 2012 is $5,441 thousand.

ii. If an impairment charge is recorded for book purposes, a deferred tax asset will result as the impairment charge cannot be recognized for tax purposes and book basis will be less than tax basis. ZAGG arrived at this number by first calculating the net value of goodwill for tax ($6,925 thousand – ($6,925 thousand/15years*1.5years)), then subtracting the net value of

goodwill for book ($6,925 thousand - $5,441 thousand), and then finally multiplying by the tax rate (38%) to arrive at $1,801 thousand.

Case 13
Johnson and Johnson

Deferred
Income Taxes

Analysis

a.

i. Defined contribution plans are plans in which the employer and employee make contributions on a regular basis. The employer's contribution is defined; there is no promise regarding amount of benefits to be paid out. Defined benefit plans are plans in which the employer is the sole contributor of the plan, and the employer is responsible for payment of defined benefits regardless of what happens in the trust fund.

ii. Retirement plan obligations are liabilities because they are future amounts that have to be paid out.

iii.

b. Service costs are the the actuarial present value of benefits attributed by the pension benefit formula to employee service during the period; it increases pension expense. Interest cost is the interest for the period on the projected benefit obligation; it increases pension expense. Actuarial gains or losses are the difference between expected and actual return on plan assets; if the expected return is more than the actual, it results in a loss; if the expected return is less than the actual, it results in a gain. Benefits paid to retirees are the amounts paid to workers already receiving pensions. These amounts decrease projected benefit obligation and decrease plan assets.

c. Actual return on plan assets are the actual increases in pension funds from interest, dividends, and realized and unrealized changes in the fair market value of the plan assets; it increases plan assets. Company contributions to the plan are cash amount paid each year by the company to the plan assets; this amount comes out of cash and increase plan assets. Benefits paid to retirees is the cash paid out of plan assets to employees already receiving pension benefits; this amount decreases projected benefit obligation and plan assets.

d. The two returns are expected and actual return on plan assets. The returns in general are increase in pensions funds from interest, dividends, and realized and unrealized changes in the fair market value of the plan assets. Expected returns are an estimated amount, calculated by multiplying a pre-determined rate by the beginning balance of plan assets; this amount decreases pension expense. The actual returns are not estimated, by are the actual amounts that are returned; this amount increases plan asset. The difference between these two amounts is an increase or decrease in other comprehensive income – gain or loss. If the expected is greater than the actual, it is a loss; if the actual is greater than the expected, it is a gain.

e.

f.

i. Johnson & Johnson reported $646 million ins pension epense, or net eriodic benefit cost, in 2007.

ii. (there is no journal entry to record service and interest cost to pension expense)

g.

i. The value at December 31, 2007 of Johnson & Johnson's retirement plan obligation is $12,002 million. The value represents the projected benefit obligation at the end of the year, after the pension expense and other changes have affected it. This number still is not perfect to the exact future retirement payments, but is as accurate as can be.

ii. The pension-related interest cost for the year is $656 million. The interest rate used is 5.63%. To conclude whether this rate seems reasonable, we would have to compare the interest rate to other companies' interest rates that are in the same industry, or are the same type of company, as Johnson & Johnson.

iii. The amount of pension benefits paid to retirees during the period is $481 million. This amount was paid out of not cash, but from the plan assets. The benefits paid decreases both the retirement plan obligation and retirement plan assets.

h.

i. The value at December 31, 2007 of Johnson & Johnson's retirement plan assets $10,469 million. This "value" is the current amount saved up in order to pay out benefits to retirees.

ii. These differences are indeed significant. In 2006, the difference was a $265 million gain, while in 2007 the difference was a $66 million loss.

iii. Johnson & Johnson contributed $317 million in 2007 and $259 million in 2006 to the retirement plan.

iv. Johnson & Johnson has divesture, acquisition, and settlement investments in their plan assets.

i. At December 31, 2007, Johnson & Johnson's retirement plan is $1,533 million under funded, and at December 31, 2006, the retirement plan is $2,112 million under funded. These amount appear on the balance sheet under noncurrent assets, current liabilities, and noncurrent liabilities as pension asset/liability. The aggregate of these balances equals the underfunded amounts.

j.

i. The actual rate of return for Plan Assets in 2007 for Johnson & Johnson is 7.79%. The difference in return in 2007 is only $66 million, compared to the $265 million in 2006. Also, the expected rate of return for 2007 is 8.48%, so the actual rate compared to the expected rate difference is less than 1% off.

ii. A larger discount rate for the retirement plan obligation will increase the interest cost for pension expense, and also increases the retirement plan obligation.

iii. Compared to 2006 and 2005, this is a .25% increase in the e of increase for compensation plans. This rate is not included in calculating pension expense.

k.

i. There is no general trend in terms of pension expense. While the pension expense increased from 2005 to 2006, it then decreased from 2006 to 2007. This may be because even though the service cost is increasing every year, the expected return on plan assets is also increasing. The interest cost is also increasing every year.