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Corporate Accountancy Case Research and Analytics

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CORPORATE ACCOUNTANCY CASE RESEARCH AND ANALYTICS

by
Elizabeth Danielle Clutton

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

Oxford
May 2018

Approved by



Advisor: Dr. Victoria Dickinson



Reader: Dr. Mark Wilder

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DEDICATION

For my family and friends, who may never understand my accounting language, but who always offer an ear to listen to me babble.

ACKNOWLEDGMENTS

My eternal gratitude belongs to Dr. Victoria Dickinson for her tireless efforts to make the daunting world of accounting into an entertaining and educational subject. Her ability to relate tough concepts to real-world scenarios is unparalleled; her roles as a mentor and as a mother do not go unnoticed. She deserves all of the medals and awards the world can give her.

ABSTRACT

ELIZABETH DANIELLE CLUTTON: Corporate Accountancy Case Research and Analytics

(Under the direction of Dr. Victoria Dickinson)

Corporate accounting is an ever-evolving beast that ebbs and flows with social and technological trends. Management faces new challenges with every interaction and must deal with the consequences. Accounting firms pioneer strategies and solutions to cope with changing regulations and accounting methods while abiding by their governing bodies. The Public Company Accounting Oversight Board as established by the Sarbanes-Oxley Act of 2002 is responsible for monitoring and correcting public companies. The Financial Accounting Standards Board established by the Financial Accounting Foundation is considered to be the Generally Accepted Accounting Standard setting body for the PCAOB. The cases discussed below all follow PCAOB and FASB guidelines.

Public companies set precedents for each other through trial and error of which accounting methods work and are correct under FASB. My research concludes how a public company should report, disclose, or record numerous scenarios.

Keywords: corporate accounting, PCAOB, FASB, GAAP, public company, accounting methods

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LIST OF ABBREVIATIONS

| | |
|-------|--|
| PCAOB | Public Company Accounting Oversight Board |
| FASB | Financial Accounting Standards Board |
| SOX | Sarbanes-Oxley Act (2002) |
| GAAP | Generally Accepted Accounting Principles |
| PV | Present Value (in reference to minimum lease payments) |

INTRODUCTION

The research contained in these twelve case studies involves a wide array of accounting topics faced by corporate accounting firms and company management. Each scenario involves an issue presented by a company and my solution for the issue. I find my answers using different accounting databases and resources, primarily in electronic form. My research involves understanding the issue addressed as it pertains to both the company of interest and my personal experience. I plan to use everything I have learned from these case studies with me into my professional career.

CASE STUDY ONE: Home Heaters, Incorporated

This scenario focuses on the operations of two comparable companies to determine which of the two is the best investment option.

Included: comparative ratios, profit performance, financial statements

Glenwood Heating, Inc. is located in Green Springs, Colorado, while Eads Heaters, Inc. is located in Eads, Colorado. Both companies operate under similar economic conditions and have identical operations during the year. While each company has positive attributes that are attractive to potential investors, my analysis has proven that Glenwood Heating, Inc. is the best company for my investment. The earnings per share, the return on assets, and the return on owners' equity are some of the attractive aspects of Glenwood Heating, Inc. that have led me to my decision. Below I will explain each of these ratios as well as the additional reasons for my investment in Glenwood Heating, Inc.

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Elizabeth Clutton

On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study.

Calculated and compared below are multiple ratios for both companies.

Comparative Ratios (Figures 1.1, 1.2):

| | Glenwood | Eads |
|------------------------------|----------|-------|
| Liquidity | | |
| Current Ratio | 4.8 | 4.73 |
| Acid-Test Ratio | 2.99 | 3.09 |
| Accounts Receivable Turnover | 4.05 | 4.22 |
| Days to Collect Receivables | 90.1 | 86.5 |
| Inventory Turnover | 2.82 | 3.7 |
| Days to Sell Inventory | 129.43 | 98.65 |

| | | |
|-----------------------|-------|-------|
| Profitability | | |
| Gross Profit Margin | .56 | .53 |
| Profit Margin | .23 | .18 |
| Return on Assets | .14 | .1 |
| Return on Equity | .4 | .34 |
| Earnings Per Share | 28.98 | 22.04 |
| Debt Ratio | .64 | .71 |
| Times Interest Earned | 5.47 | 3.69 |

Skimming over these comparative ratios gives the investor a snap shot of each company's liquidity and profitability. It appears that Eads and Glenwood each have areas where their numbers are stronger in comparison to the other company. Glenwood has a better Current Ratio, Gross Profit Margin, Profit Margin, and Return on Assets, among others. Eads has better Accounts Receivable Turnover, Days to Collect Receivables, Inventory Turnover, and Days to Sell Inventory, among others. While these comparative ratios provide insight into the basic performance of a company, a closer examination is required to determine which company is the better investment.

Glenwood Heating, Inc.

Eads Heaters, Inc.

(Figure 1.3)

| | |
|---------------------------------|----------------------------------|
| Return on Assets 0.14 | Return on Assets 0.1 |
| Return on Owners' Equity 0.4 | Return on Owners' Equity 0.34 |
| Earnings Per Share 28.98 | Earnings Per Share 22.04 |

Return on Assets:

Glenwood Heating, Inc. has .04 (almost 5%) better Return on Assets than Eads Heaters, Inc. Both companies have identical assets (land, building), but Eads chooses to acquire equipment on a capital lease agreement while Glenwood chooses to rent its equipment. This capital lease agreement means that Eads increases its assets but not its Net Income, resulting in a lower Return on Assets. While Eads has the advantage of actually owning its equipment, Glenwood has the advantage of adaptability. Consumers in the future may desire a different type of product, and Glenwood will be able to transform with the times because it is not tied to a lease agreement.

Return on Owners' Equity:

Glenwood has a 6% higher Return on Owners' Equity than Eads even though both companies have the same amount of Common Stock invested. Glenwood has \$22,227 (\$92,742 -- \$70,515 = \$22,227) greater Net Income than Eads, resulting in a higher Return on Owners' Equity.

Earnings Per Share:

Because Glenwood has a higher Net Income than Eads, it has higher Earnings per Share. Eads' shares are worth \$6.94 less than Glenwood's share—a large margin considering both companies began with the same conditions.

Glenwood Heating, Inc.

Eads Heaters Inc.

(Figure 1.4)

| | |
|-----------------------|-----------------------|
| Profit Margin 0.23 | Profit Margin 0.18 |
| Debt Ratio 0.64 | Debt Ratio 0.71 |

Profit Margin:

Clearly an attractive ratio, Glenwood's Profit Margin is 5% higher than Eads' Profit Margin. Investors want a company that provides them with a substantial return for their money, and Glenwood's higher Net Income impacts Profit Margin, Retained Earnings, and Earnings per Share. Eads' accounting decisions took them from on par with Glenwood to below Glenwood's operations.

Debt Ratio:

Eads' Debt Ratio is higher than Glenwood's Debt Ratio. This ratio is a direct result of Eads' decision to lease their equipment rather than buy their equipment. Eads is stuck paying 8% interest every year for 8 years as opposed to Glenwood who is only paying \$16,000 each year for the two years it has agreed to rent. Investors look for a company that has cash available for expansion endeavors instead of cash tied into liabilities.

Below is each company's Statement of Cash Flows.

(Figure 1.6)

| Glenwood Heating Inc. | | |
|---|-------------------------|-----------------------|
| Statement of Cash Flows | | |
| For Year Ended December 31, 20X1 | | |
| Cash from Operating | | |
| Net Income | | 92,742 |
| Accounts Receivable | | <99,400> |
| Accounts Payable | | 26,440 |
| Interest Payable | | 6650 |
| Depreciation Expense | | 19,000 |
| Increase in Inventory | | <62,800> |
| Bad Debts Expense | | <u>994</u> |
| | Net Cash from Operating | <16,374> |
| Cash from Investing | | |
| Land | | <70,000> |
| Building | | <350,000> |
| Equipment | | <u><80,000></u> |
| | Net Cash from Investing | <500,000> |
| Cash from Financing | | |
| Common Stock | | 160,000 |
| Dividends | | <23,200> |
| Increase in Notes Payable | | <u>380,000</u> |
| | Net Cash from Financing | 516,800 |
| Net Cash Provided | | <u>426</u> |

(Figure 1.7)

| Eads Heaters Inc. | | |
|---|-------------------------|-----------------------|
| Statement of Cash Flows | | |
| For Year Ended December 31, 20X1 | | |
| Cash from Operating | | |
| Net Income | | 70,515 |
| Accounts Receivable | | <99,400> |
| Accounts Payable | | 26,440 |
| Interest Payable | | 6,650 |
| Depreciation Expense | | 41,500 |
| Increase in Inventory | | <51,000> |
| Bad Debts Expense | | <u>4,970</u> |
| | Net Cash from Operating | <325> |
| Cash from Investing | | |
| Land | | <70,000> |
| Building | | <350,000> |
| Equipment | | <80,000> |
| Leased Equipment | | <u><92,000></u> |
| | Net Cash from Investing | <592,000> |
| Cash from Financing | | |
| Common Stock | | 160,000 |
| Dividends | | <u><23,200></u> |
| Increase in Notes Payable | | 380,000 |
| Increase in Lease Payable | | 83,360 |
| | Net Cash from Financing | <u>600,160</u> |
| Net Cash Provided | | 7,835 |

At first glance, it appears that Eads' net cash provided is much greater than Glenwood's net cash provided, but there are other numbers investors should consider. Going in sequential order, the first focus is Depreciation Expense. Glenwood chose to depreciate its equipment using the straight-line depreciation method while Eads chose to use the double-declining method. By using the double-declining method, Eads accounts for more depreciation, positively affecting its cash flow. The next account to focus on is the Inventory account. Glenwood uses the FIFO inventory method while Eads uses the LIFO inventory method. As shown in the charts given in the problem, each company's inventory is valued higher later in the year. This idea means that with the FIFO method, Glenwood has higher-valued inventory remaining, which in turn decreases its cash flow from operations. The last account investors should focus on is the Bad Debts Expense. Glenwood chose to estimate its bad debts as 1% of accounts receivable while Eads chose to estimate its bad debts expense as 5% of accounts receivable. This means that Eads shows \$3,976 more bad debts expense than Glenwood.

For companies in their first year of existence, cash flow from operations is an important factor for potential investors. Although Glenwood has a smaller net cash flow from operating, the numbers and decisions that underlie the <\$16,374> prove that Glenwood's cash flow from operations is justified. With alterations in Glenwood's application of GAAP, this number could look very different.

For further detail into each company's first year of operations, I have provided the financial statements for both Glenwood and Eads.

Glenwood Heating Inc.: (Figure 1.8)

| | | Glenwood Heating Inc. | |
|-------------------------------------|---|---|----------------|
| | | Income Statement | |
| | | For Year Ended Decmeber 31, 20X1 | |
| Sales | | | \$398,500 |
| Cost of Goods Sold | | | <u>177,000</u> |
| Gross Profit | | | 221,500 |
| Selling and Administrative Expenses | | | |
| | Bad Debt Expense | 994 | |
| | Depreciation Expense | 19,000 | |
| | Other Operating Expenses | 34,200 | |
| | Rent Expense | <u>16,000</u> | |
| | Total Selling and Administrative Expenses | | <u>70,194</u> |
| Income from Operations | | | 151,306 |
| Other Expenses | | | |
| | Interest Expense | | <u>27,650</u> |
| Income Before Taxes | | | 123,656 |
| | Provision for Income Taxes | | <u>30,914</u> |
| Net Income | | | <u>92,742</u> |

| | | Glenwood Heating Inc. | |
|-----------------------------|------------------|---|-----------------------|
| | | Statement of Retained Earnings | |
| | | For Year Ended Decmeber 31, 20X1 | |
| Beginning Retained Earnings | | | . |
| | Plus: Net Income | | 92,742 |
| | Less: Dividends | | <u><23,200></u> |
| Ending Retained Earnings | | | 69,542 |

Eads Heaters, Inc.: (Figure 1.9)

| Eads Heaters Inc. | | | |
|---|---|--------------------------------|-----------------------|
| Income Statement | | | |
| For Year Ended Decmeber 31, 20X1 | | | |
| Sales | | | 398,500 |
| Cost of Goods Sold | | | <u>188,800</u> |
| Gross Profit | | | 209,700 |
| Selling and Administrative Expenses | | | |
| | Bad Debt Expense | 4,970 | |
| | Depreciation Expense | 41,500 | |
| | Other Operating Expenses | 34,200 | |
| | Rent Expense | <u> .</u> | |
| | Total Selling and Administrative Expenses | | <u>80,670</u> |
| Income from Operations | | | 129,030 |
| Other Expenses | | | |
| | Interest Expense | | 35,010 |
| Income Before Taxes | | | 94,020 |
| | Provision for Income Taxes | | <u>23,050</u> |
| Net Income | | | <u>70,515</u> |
| | | Liabilities and Owners' Equity | |
| Eads Heaters Inc. | | | |
| Statement of Retained Earnings | | | |
| For Year Ended Decmeber 31, 20X1 | | | |
| Beginning Retained Earnings | | | . |
| | Plus: Net Income | | 70,515 |
| | Less: Dividends | | <u><23,200></u> |
| Ending Retained Earnings | | | 47,315 |
| Stockholders' Equity | | | |
| | Common Stock | | 160,000 |
| | Retained Earnings | 92,742 | |
| | | Less: Dividends | 23,200 |
| | | | <u>69,542</u> |
| | Total Equity | | 229,542 |
| | Total Liabilites and Stockholders' Equity | | <u>642,632</u> |

| Glenwood Heating Inc. | | | |
|---|---------------------------|--|-----------------------|
| Statement of Cash Flows | | | |
| For Year Ended December 31, 20X1 | | | |
| Cash from Operating | | | |
| | Net Income | | 92,742 |
| | Accounts Receivable | | <99,400> |
| | Accounts Payable | | 26,440 |
| | Interest Payable | | 6650 |
| | Depreciation Expense | | 19,000 |
| | Increase in Inventory | | <62,800> |
| | Bad Debts Expense | | <u>994</u> |
| | Net Cash from Operating | | <16,374> |
| Cash from Investing | | | |
| | Land | | <70,000> |
| | Building | | <350,000> |
| | Equipment | | <u><80,000></u> |
| | Net Cash from Investing | | <500,000> |
| Cash from Financing | | | |
| | Common Stock | | 160,000 |
| | Dividends | | <23,200> |
| | Increase in Notes Payable | | <u>380,000</u> |
| | Net Cash from Financing | | 516,800 |
| Net Cash Provided | | | <u>426</u> |

| Eads Heaters Inc. | | |
|---|---------------------------|-----------------------|
| Statement of Cash Flows | | |
| For Year Ended December 31, 20X1 | | |
| Cash from Operating | Net Income | 70,515 |
| | Accounts Receivable | <99,400> |
| | Accounts Payable | 26,440 |
| | Interest Payable | 6,650 |
| | Depreciation Expense | 41,500 |
| | Increase in Inventory | <51,000> |
| | Bad Debts Expense | <u>4,970</u> |
| | Net Cash from Operating | <325> |
| Cash from Investing | Land | <70,000> |
| | Building | <350,000> |
| | Equipment | <80,000> |
| | Leased Equipment | <u><92,000></u> |
| | Net Cash from Investing | <592,000> |
| Cash from Financing | Common Stock | 160,000 |
| | Dividends | <u><23,200></u> |
| | Increase in Notes Payable | 380,000 |
| | Increase in Lease Payable | 83,360 |
| | Net Cash from Financing | <u>600,160</u> |
| Net Cash Provided | | 7,835 |

| Eads Heaters Inc. | | |
|--------------------------------|--|----------------|
| Balance Sheet | | |
| December 31, 20X1 | | |
| Assets | | |
| Current Assets | Cash | 7,835 |
| | Accounts Receivable | 99,400 |
| | Less: Allowance for Doubtful Accounts | <u>4,970</u> |
| | | 94,430 |
| | Inventory | <u>51,000</u> |
| | Total Current Assets | 153,265 |
| Long-Term Assets | Land | 70,000 |
| | Building | 350,000 |
| | Less: Accumulated Depreciation | <u>10,000</u> |
| | | 340,000 |
| | Equipment | 80,000 |
| | Less: Accumulated Depreciation | <u>20,000</u> |
| | | 60,000 |
| | Leased Equipment | 92,000 |
| | Less: Accumulated Depreciation | <u>11,500</u> |
| | | <u>80,500</u> |
| | Total Long-Term Assets | <u>550,000</u> |
| | Total Assets | <u>703,765</u> |
| Liabilities and Owners' Equity | | |
| Current Liabilities | Accounts Payable | 26,440 |
| | Interest Payable | <u>6,650</u> |
| | Total Current Liabilities | 33,090 |
| Long-Term Debt | Notes Payable | 380,000 |
| | Lease Payable | <u>83,360</u> |
| | Total Long-Term Liabilities | 463,360 |
| | Total Liabilities | 496,450 |
| Stockholders' Equity | Common Stock | 160,000 |
| | Retained Earnings | 70,515 |
| | Less: Dividends | <u>23,200</u> |
| | | <u>47,315</u> |
| | Total Equity | 207,315 |
| | Total Liabilities and Stockholders' Equity | <u>703,765</u> |

Conclusion

After examining each company's comparative ratios and financial statements, I conclude that Glenwood Heating, Inc. serves as the best investment. While Eads Heaters, Inc. has promising numbers, its accounting decisions lead to insufficient Return on Stockholders' Equity, Earnings Per Share, and Profit Margin. With slight alteration to its application of GAAP, Glenwood Heating Inc. could display positive cash flow from operations and will have an encouraging potential for good investment.

CASE STUDY TWO: Totz and Doodlez

This scenario focuses on the FASB Codification, a database that contains accounting guidelines applicable to any public company that follows GAAP.

Totz Company's financial statements are justified as being presented correctly utilizing the Financial Accounting Standards Board's Codification Research System.

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Elizabeth Clutton

On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study.

Using the Financial Accounting Standards Board Accounting Standards Codification, I have justified the presentation of Totz's Income Statement.

1. Totz recognized an increase in net sales resulting from an increase in revenue from services provided by Doodlez and an increase in the average transaction value. According to ASC 225-10-S99-2-1d, Totz must "state separately (a) Net sales of tangible products; (b) operating revenues of public utilities or others; (c) income from rentals; (d) revenues from services; (e) other revenues." Totz should disclose the increase in revenues from services provided by Doodlez separately from its net income from sale of children's clothing.
2. Totz gross profit increased in addition to an increase in the cost of goods sold recorded. This increase in the cost of goods sold is a result of an increase in the cost of Doodlez' services. According to ASC 255-10-55-17, there is a section for reporting the "Statement of Income from Continuing Operations Adjusted for Changing Prices." This specific Income Statement "reflects effects of changes in the specific prices (current cost) of inventory and property, plant, and equipment expressed in units of constant purchasing power" (ASC 255-10-55-17). Totz will show a separate Income Statement section to record the change in prices affecting its increased cost of goods sold.
3. Totz relocated its headquarters and sold its abandoned building, realizing a gain on the sale. According to ASU 225-10-45-4, Totz's sale of headquarters qualifies as "usual in nature" and is "consequence of customary and continuing business activities." Further justification is found in ASC 360-10-45-9: "A long-lived asset (disposal group) to be sold shall be classified as held for sale in the period in

which all of the following criteria are met: (a) Management, having the authority to approve the action, commits to a plan to sell the asset (disposal group).”

Therefore, Totz records this gain in its Income Statement before income tax per usual.

4. Totz settled a class action lawsuit and received proceeds from the settlement.

According to ASC 450-30-25-1, “A contingency that might result in a gain usually should not be reflected in the financial statements because to do so might be to recognize revenue before its realization.” Accompanying this justification,

A material event or transaction that is unusual in nature or occurs infrequently but not both does not meet the criteria for classification as an extraordinary item, shall be reported as a separate component of income from continuing operations. The nature and financial effects of each event or transaction shall be disclosed on the face of the income statement or, alternatively, in notes to financial statements (ASC 225-20-45-16)

Totz has the option to record this contingency either in a separate component of the income statement or in the notes to the financial statement.

Conclusion

Once comfortable navigating the website structure, I found the section that contains each accounting topic Totz covers. The Codification explains why and how an accounting method should be used to report correctly under GAAP. The Codification is now a resource that I feel confident using to research any reporting issues I may find.

CASE STUDY THREE: Rocky Mountain Chocolate Factory

This scenario offers the financial statements for Rocky Mountain Chocolate Factory, a public company that operates under FASB standards.

Included below are the balance sheet and income statement, as well as the trial balance and certain journal entries for Rocky Mountain Chocolate Factory.

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On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study.

(Figures 3.1-3.5)

| | | | | |
|---------------|----|--|-------------------------------------|------------------------|
| | 1 | Inventory RM Accounts Payable | 7,500,000 | |
| | 2 | Inventory WIP Wages Pay | 6,000,000 | 7,500,000 |
| | 3 | Cash Accounts Rec. Sales Revenue | 17,000,000 5,000,000 | 6,000,000 |
| | | COGS Inventory FG | 14,000,000 | 22,000,000 |
| | 4 | Accounts Payable Cash | 8,200,000 | 14,000,000 |
| | 5 | Cash Accounts Rec. | 4,100,000 | 8,200,000 |
| | 6 | Sales and Market Exp Gen & Admin Exp Retail Oper Exp Cash Accrued Expenses | 1,505,431 2,044,569 1,750,000 | 4,100,000 |
| | 7 | Wages Exp Cash | 6,423,789 | 2,000,000 3,300,000 |
| | 8 | Cash Unearned Revenue | 125,000 | 6,423,789 |
| | 9 | PPE Cash | 498,332 | 125,000 |
| | 10 | Retained Earnings Cash Dividends Pay | 2,407,167 | 498,332 |
| ADJ1 | | Cost of sales Inventories | 216,836 | 2,403,458 3,709 |
| ADJ2 | | Depreciation and amortization expense Property and Equipment, net | 698,580 | 216,836 |
| ADJ3 | | NO entry | | |
| Closing entry | | Income Summary | | 698,580 |
| | | Cost of sales | | |
| | | Franchise costs | 24,883,681 | |
| | | Sales and Marketing | | |
| | | General and Administrative | | |
| | | Retail Operating | | 14,910,622 |
| | | Income Tax Expense | | 1,499,477 |
| | | Depreciation and | | 1,505,431 |
| | | Amortization | | 2,422,147 |
| | | Sales | | 1,756,956 |
| | | Interest Income | | 2,090,468 |
| | | Franchise and royalty fees | 22,944,017 | 698,580 |
| | | Income summary | 27,210 | |
| | | | 5,492,531 | |
| | | Income Summary | | |
| | | Retained Earnings | 3,580,077 | 28,463,758 |
| | | | | 3,580,077 |

| | Beginning balance (February 28, 2009) | Purchase Inventory | Incur Factory wages | Sell Inventory for cash and on account | Pay for Inventory | Collect receivables) | Incur SG&A (cash and payable) | Pay Wages | Receive franchise fee | Purchase PPE | Dividends declared and paid | All other transactions | Unadjusted Trial Balance | Adjust for Inventory | Record depreciation | Wages accrual | Consultant's report | Pre-closing Trial balance | Closing entry | Post-closing (ending) balance |
|--|---------------------------------------|--------------------|---------------------|--|-------------------|-----------------------|-------------------------------|---------------|-----------------------|--------------|-----------------------------|------------------------|--------------------------|----------------------|---------------------|---------------|---------------------|---------------------------|---------------|-------------------------------|
| Cash and cash equivalents | 1,253,947 | | | 17,000,000 | -8,200,000 | 4,100,000 | -2,000,000 | -6,423,789 | 125,000 | 498,832 | -2,403,458 | 790,224 | 3,743,092 | | | | | 3,743,092 | | 3,743,092 |
| Accounts Receivable | 4,229,733 | | 1 | 5,000,000 | | 4,100,000 | | | | | | -702,207 | 4,427,526 | | | | | 4,427,526 | | 4,427,526 |
| Notes Receivable, current | 0 | | | | | | | | | | | 91,059 | 91,059 | | | | | 91,059 | | 91,059 |
| Inventories | 4,064,611 | 13,500,000 | | -14,000,000 | | | | | | | | -66,328 | 3,498,283 | -216,836 | | | | 3,281,447 | | 3,281,447 |
| Deferred Income Taxes | 369,197 | | | | | | | | | | | 92,052 | 461,249 | | | | | 461,249 | | 461,249 |
| Other | 224,378 | | | | | | | | | | | -4,215 | 220,163 | | | | | 220,163 | | 220,163 |
| Property and Equipment, Net | 5,253,598 | | | | | | | | | 498,832 | | 132,859 | 5,885,289 | | -698,580 | | | 5,186,709 | | 5,186,709 |
| Notes Receivable, less current portion | 124,452 | | | | | | | | | | | 139,198 | 263,650 | | | | | 263,650 | | 263,650 |
| Goodwill, net | 1,046,944 | | | | | | | | | | | | 1,046,944 | | | | | 1,046,944 | | 1,046,944 |
| Intangible assets, net | 183,135 | | | | | | | | | | | -73,110 | 110,025 | | | | | 110,025 | | 110,025 |
| Other | 91,057 | | | | | | | | | | | -3,007 | 88,050 | | | | | 88,050 | | 88,050 |
| Accounts Payable | 1,074,643 | 7,500,000 | | -8,200,000 | | | | | | | | 503,189 | 877,832 | | | | | 877,832 | | 877,832 |
| Accrued salaries and wages | 423,789 | | 6,000,000 | | | | | -6,423,789.00 | | | | | 0 | | | 646,156 | | 646,156 | | 646,156 |
| Other accrued expenses | 531,941 | | | | | | 3,300,000 | | | | | -2,885,413 | 946,528 | | | | | 946,528 | | 946,528 |
| Dividend payable | 598,986 | | | | | | | | | | 3,709 | -1 | 602,694 | | | | | 602,694 | | 602,694 |
| Deferred Income | 142,000 | | | | | | | | 125,000 | | | -46,062 | 220,938 | | | | | 220,938 | | 220,938 |
| Deferred Income Taxes | 827,700 | | | | | | | | | | | 66,729 | 894,429 | | | | | 894,429 | | 894,429 |
| Common Stock | 179,696 | | | | | | | | | | | 1,112 | 180,808 | | | | | 180,808 | | 180,808 |
| Additional Paid-in Capital | 7,311,280 | | | | | | | | | | | 315,322 | 7,626,602 | | | | | 7,626,602 | | 7,626,602 |
| Retained Earnings | 5,751,017 | | | | | | | | | | -2,407,167 | | 3,343,850 | | | | | 3,343,850 | 3,580,077 | 6,923,927 |
| Sales | 0 | | | 22,000,000 | | | | | | | | 944,017 | 22,944,017 | | | | | 22,944,017 | -22,944,017 | 0 |
| Franchise and royalty fees | 0 | | | | | | | | | | | 5,492,531 | 5,492,531 | | | | | 5,492,531 | -5,492,531 | 0 |
| Cost of sales | 0 | | | 14,000,000 | | | | | | | | 693,786 | 14,693,786 | 216,836 | | | | 14,910,622 | -14,910,622 | 0 |

| | | | | | | | | | | | | | | | | | | | |
|-------------------------------|---|--|--|--|--|--------------|--|--|--|--|-----------|-----------|--|---------|--|--|-----------|------------|---|
| Sales & Marketing | 0 | | | | | 1,505,431.00 | | | | | | 1,505,431 | | | | | 1,505,431 | -1,505,431 | 0 |
| General and Administrative | 0 | | | | | 2,044,569.00 | | | | | -261,622 | 1,782,947 | | 639,200 | | | 2,422,147 | -2,422,147 | 0 |
| Retail Operating | 0 | | | | | 1,750,000 | | | | | | 1,750,000 | | 6,956 | | | 1,756,956 | -1,756,956 | 0 |
| Depreciation and amortization | 0 | | | | | | | | | | | 0 | | 698,580 | | | 698,580 | -698,580 | 0 |
| Interest income | 0 | | | | | | | | | | -27,210 | -27,210 | | | | | -27,210 | 27,210 | 0 |
| Income Tax Expense | 0 | | | | | | | | | | 2,090,468 | 2,090,468 | | | | | 2,090,468 | -2,090,468 | 0 |

| Rocky Mountain Chocolate Factory Inc. | |
|---|-------------------|
| Income Statement | |
| For the year ended Feb 28, 2010 | |
| Revenues | |
| Sales | 22,944,017 |
| Franchise and royalty fees | 5,492,531 |
| Total revenues | 28,436,548 |
| Cost and Expenses | |
| Cost of sales | 14910622 |
| Franchise costs | 1499477 |
| Sales & Marketing | 1505431 |
| General and Administrative | 2422147 |
| Retail Operating | 1756956 |
| Depreciation and amortization | 698580 |
| Total costs and expenses | 22,793,213 |
| Operating Income | 5,643,335 |
| Other Income (Expense) | |
| Interest expense | |
| Interest income | 27,210 |
| Other | 27,210 |
| Income Before Income Taxes | 5,670,545 |
| Income Tax Expense | 2,090,468 |
| Net Income | 3,580,077 |
| Basic Earnings per Common Share | 0.60 |
| Diluted Earnings per Common Share | 0.58 |
| Weighted Average Common Shares Outstanding | 6,012,717 |
| Dilutive Effect of Employee Stock Options | 197,521 |
| Weighted Average Common Shares Outstanding, Assuming Dilution | 6,210,238 |

| | |
|---|----------------------|
| Rocky Mountain Chocolate Factory Inc. Balance Sheet As of February 28, 2010 | |
| Assets | |
| Current Assets | |
| Cash and cash equivalents | \$ 3,743,092 |
| Accounts Receivable | \$ 4,427,526 |
| Notes Receivable, current | \$ 91,059 |
| Inventories | \$ 3,281,447 |
| Deferred Income Taxes | \$ 461,249 |
| Other | \$ 220,163 |
| Total current assets | \$ 12,224,536 |
| | |
| Property and Equipment, Net | \$ 5,186,709 |
| | |
| Other assets | |
| Notes Receivable, less curent portion | \$ 263,650 |
| Goodwill, net | \$ 1,046,944 |
| Intangible assets, net | \$ 110,025 |
| Other | \$ 88,050 |
| Total other assets | \$ 1,508,669 |
| | |
| Total assets | \$ 18,919,914 |
| | |
| Liabilities and Stockholders' Equity | |
| Current Liabilities | |
| Accounts Payable | \$ 877,832 |
| Accrued salaries and wages | \$ 646,156 |
| Other accrued expenses | \$ 946,528 |
| Dividend payable | \$ 602,694 |
| Deferred Income | \$ 220,938 |
| Total Current Liabilities | \$ 3,294,148 |
| | |
| Deferred Income Taxes | \$ 894,429 |
| | |
| Commitments and Contingencies | |
| | |
| Stockholders' Equity | |
| Preferred stock \$0.1 par value; 250,000 authorized; 0 shares outstanding | |
| Senior A Junior Participating Preferred Stock, authorizes 50,000 shares | |
| Undesignated series, authorized 200,000 shares | |

| | | |
|---|-----------|-------------------|
| Common Stock, \$0.3 par value; 100,000,000 shares authorized; 6,026,938 and 5,989,858 shares issued and outstanding respectively | \$ | 180,808 |
| Additional Paid-in Capital | \$ | 7,626,602 |
| Retained Earnings | \$ | 6,923,927 |
| Total Stockholders' equity | \$ | 14,731,337 |
| | | |
| Total Liabilities and Stockholders' | \$ | 18,919,914 |

| | Type of Transaction | Type of Cash Flow Activity |
|----|---|----------------------------|
| 1 | Purchase of Inventory | operating |
| | | |
| 2 | Incur factory wages | operating |
| | | |
| 3 | Sale of inventory (Cash and on account) | operating |
| | | |
| 4 | Pay for the inventory | operating |
| | | |
| 5 | Collect receivables | operating |
| | | |
| 6 | Incur SG&A (cash and payable) | operating |
| | | |
| 7 | Pay wages | operating |
| | | |
| 8 | Receive franchise fees | operating |
| | | |
| 9 | Purchase PPE | investing |
| | | |
| 10 | Declaration of dividends | financing |
| | | |
| 11 | Other transactions | - |
| | | |
| 12 | Adjust for inventory count | operating |
| | | |
| 13 | Record depreciation | operating |
| | | |
| 14 | Wage Accrual | operating |

Conclusion

The financial statements a company prepares are useful to both internal and external users. A public company such as Rocky Mountain Chocolate Factory is required to undergo a yearly audit that prepares and presents its financial statements to external users. These statements offer investors peace of mind because of the credibility offered by the audit as well as the ability to look at the numbers for themselves.

CASE STUDY FOUR: Fraudulent Activities and Implementation of Internal Controls

This scenario shows different situations faced by employees in their daily operations. Each of these situations demonstrates an area where an internal control should be in place to prevent fraudulent activity. The Sarbanes-Oxley Act of 2002 discussed further in CASE STUDY SIX: WorldCom is the main enforcer of internal controls of a public company.

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(Figure 4.1)

| Fraud Scheme | Internal Control |
|--|---|
| Lack of a time clock enables employees to lie about the time they have worked. | <u>Update Technology:</u> the company should utilize an electronic time management system to log hours worked |
| An employee accepts a check for merchandise and completely bypasses the electronic system. | <u>Perform a Physical Audit:</u> An employee should periodically perform a physical inventory count to reconcile the actual stock number to the electronic stock number |

| | |
|---|---|
| <p>Since there is not a physical inventory count and all employees have authority to enter all types of transactions, an employee can make a sale and then create a false return right after and pocket the cash from the sale.</p> | <p><u>Separation of Duties:</u> Only one employee should be allowed to perform each task</p> <p><u>Approval Authority:</u> A manager should provide approval before an employee can make any abnormal transaction</p> |
| | <p><u>Perform a Physical Audit:</u> An employee should periodically perform a physical inventory count to reconcile the actual stock number to the electronic stock number</p> |

| | |
|--|--|
| <p>During a transaction a discount is added to the full price for customer to pay. The system shows entire price recorded, but the employee pockets difference between full price and full price plus the discount that the customer pays.</p> | <p><u>Perform a Physical Audit:</u> An employee should periodically perform a physical inventory count to reconcile the actual stock number to the electronic stock number. Cash should be accounted for after each shift.</p> |
| <p>Lack of security measures make it easy for employees to steal merchandise.</p> | <p><u>Physical Measures:</u> Physical security systems should be in place to deter and prevent or record any unacceptable behavior.</p> |

The business is running on a simple accounting software.

Update Technology: The accounting system should be updated. Updates account for more safeguards against issues the business may run into.

Lucy handles minor customer complaints. She could fake a complaint asking for a refund and then pocket the money for the refund.

Separation of Duties: A physical record of each employee complaint in addition to the customer's name and phone number should be taken down. A manager should read and deal with each customer complaint. The manager dealing with the issue looks better for the business and prevents this type of error from occurring.

| | |
|---|--|
| <p>Employees can disguise fraud by using another employee's access code to the register.</p> | <p><u>Access Controls:</u> Every employee should be assigned a unique log-in identification.</p> <p><u>Separation of Duties:</u> Only one employee should operate on each computer. The log-in IDs should be used to determine who is making the transactions.</p> |
| <p>Lucy has access to the accounting system and thus the inventory system; she can alter the inventory to cover up discrepancies in sales and the electronic inventory count.</p> | <p><u>Access Controls:</u> The unique log-in ID given to each employee will deter any unacceptable behavior.</p> <p><u>Separation of Duties:</u> One employee should check the other employee's transactions in the computer.</p> |

| | |
|---|---|
| <p>Employees are authorized to enter all types of transactions.</p> | <p><u>Approval Authority:</u> Only management should be allowed to enter certain types of transactions into the computer. Manager approval should be required.</p> |
| <p>Lucy summarizes and records daily sales in the accounting system and prepares bank deposits.</p> | <p><u>Separation of Duties:</u> Lucy should only have access to perform one of these tasks. Another employee should check Lucy's numbers and prepare the bank deposits independent of Lucy's influence.</p> |

Conclusion

Internal controls are extremely important for any company, public or private. Private companies are not required to undergo an audit over their internal controls, but public companies do have to fill this obligation on a yearly basis. This case shows how many areas of a company's operations are affected by not having the proper internal control in place. Internal controls serve to protect both the company and the investors and are an extremely important aspect of modern accounting.

CASE STUDY FIVE: Inventory Assessment

This scenario discusses the options available to a company who accounts for inventory in its financial statements. A discussion follows that concludes on what other facts besides raw inventory numbers are important to an investor making an investment decision.

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1. In the raw materials inventory, we should expect to see storage and spoilage costs. In the works in process inventory, we should expect to see storage, labor, and allowance for mistakes costs. In finished goods, we should expect to see storage, spoilage, reworking, freight-out, and maintenance costs.
2. The inventory balance is recorded net of an estimated allowance for obsolete or unmarketable inventory. This estimate is based upon current inventory levels, sales trends and historical experience as well as management's estimates of market conditions and forecasts of future product demand.
3.
 - a) This account will appear on the Balance Sheet in the Current Assets section.
 - b) $233,070 + 10,800 = 243,870$
 $211,734 + 12,520 = \underline{224,254} = 468,124$
 - c) Raw Material could account for the damaged or "bad" supplies. Works in Process could include products not manufactured properly. Finished Goods would account for the largest portion of the reserve for obsolete inventory. It could include spoilage or damaged products.

| | | |
|----------------------------|--------|--------|
| 4. Cost of Goods Sold | 13,348 | |
| Inventory | | 13,348 |
| Write-off, Disposal, other | 11,628 | |
| Inventory | | 11,628 |

| | |
|--|--|
| 5. <u>Raw Materials</u> 46,976 84,388 <hr style="width: 80%; margin-left: 0;"/> <div style="text-align: right; margin-right: 20px;">87,895</div> <hr style="width: 80%; margin-left: 0;"/> 43,469 | <u>Works in Process</u> 1,286 126,000 87,895 <hr style="width: 80%; margin-left: 0;"/> <div style="text-align: right; margin-right: 20px;">214,562</div> <hr style="width: 80%; margin-left: 0;"/> 619 |
|--|--|

| | |
|--|--|
| <u>Finished Goods, net</u> 184,808 <div style="text-align: right; margin-right: 20px;">13,348</div> 214,562 <hr style="width: 80%; margin-left: 0;"/> <div style="text-align: right; margin-right: 20px;">218,376</div> <hr style="width: 80%; margin-left: 0;"/> 164,646 | <u>Cost of Sales</u> 0 13,348 <u>218,376</u> <hr style="width: 80%; margin-left: 0;"/> 231,724 |
|--|--|

| |
|-------------------------|
| <u>Accounts Payable</u> |
| 39,012 |
| <u>84,388</u> |
| 45,376 |

6. 2012: $\$585,897 / [(\$211,734 + \$233,070) / 2] = \2.63
 2011: $\$575,226 / [(\$233,070 + \$268,591) / 2] = \2.29
7. 2012: $365 / \$2.63 = 139$ days

2011: $365 / \$2.29 = 159$ days

The company is becoming more efficient in its inventory management. This is seen in the difference of 159 days it took the company to overturn its inventory in 2011 as compared to the 139 days it took the company to overturn its inventory in 2012.

8. 2012: $(211,734 + 12,520) / 12,520 = 17.91\%$
2011: $(233,070 + 10,800) / 10,800 = 22.58\%$

As an investor, I would like to see additional ratios such as: Current Ratio, Asset Turnover Ratio, Debt to Equity Ratio, Debt to Asset Ratio, Working Capital Ratio, and Quick Ratio.

Conclusion

Inventory management is important for a company whose main operations involve turning over the inventory on hand in order to make a profit. Inventory is an asset on the books, and therefore, can make a company appear either profitable or not. Management must assess how to account for inventory as well as the areas for improvement. Ratios are the easiest way to present inventory numbers to a potential investor, so these ratios need to prove good inventory management.

CASE STUDY SIX: WorldCom, Incorporated

This scenario examines the WorldCom case where improper accounting led to the downfall of an entire business as well as a Big Five International Accounting Firm. After management and the auditors made the poor decisions they made, both WorldCom and Arthur Andersen ceased to exist.

Explained below is an evaluation and analysis of the incorrect accounting procedures used by the accountants at Arthur Andersen and WorldCom that ultimately led to the dissolution of both companies.

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- a.
- i. SCON 6 defines an “asset” as anything that will provide a future benefit (a future utility) for the company based on a past event. SCON 6 defines “expense” as putting those assets to use, and subsequently taking those assets off the books, by rendering a service.
 - ii. Costs should be expensed when they are ordinary costs and capitalized when they will provide the company future utility.
- b. If a company decides to capitalize its expenses, it will not report the entire impact of those expenses when incurred, but will amortize it over the life of the asset. This follows the matching principle if the asset has a long useful life and will generate future revenue for the company. When management decides to capitalize expenses it affects these financial statement figures:
- Net Income: If a company capitalizes expenses, it will have a higher profitability in the beginning because it does not show those items as expenses taken from revenues.
 - Stockholders’ Equity: As a result of a higher net income in the initial years, the company will have higher retained earnings.
 - Assets: If a company capitalizes its costs, it will have higher total assets because it is not recognizing those assets less expenses yet.
- c. WorldCom reported \$14,739 million in line costs. Line costs “consist principally of access charges and transport charges” (5 WorldCom, Inc.).

| | |
|------------------|----------------|
| Line Costs (Exp) | 14,739,000,000 |
| Cash | 14,739,000,000 |

| | |
|--|------------------------------|
| g. Income before taxes, as reported | \$2,393,000,000 |
| Add back Depreciation for the year | 83,306,820 |
| Deduct Line Costs that were improperly capitalized | <u><3,055,000,000></u> |
| Loss Before Taxes, restated | <578,693,180> |
| Income Tax Benefit | 202,542,613 |
| Minority Interest | <u>35,000,000</u> |
| Net Loss, restated | <\$341,150,567> |

Conclusion

WorldCom and the accountants from Arthur Andersen colluded to improperly record expenses on WorldCom's financial statements. FASB issues standards on how to account for each type of expense because of the different implications each has: a capital expense results from an asset that continues to benefit a company for many years, while an ordinary expense is expenses immediately in the current year when the asset serves its purpose. An improper record of these expenses will overstate revenue and understate expenses, making a company appear more profitable than in reality. Both the Enron and WorldCom scandals rocked the accounting world and ultimately lead to the Sarbanes-Oxley Act of 2002. The SOX Act provides guidance over internal control procedures that attempt to prevent collusion and fraud.

CASE STUDY SEVEN: Targa Company

This scenario describes a business during the middle of a restructure. Management is faced with preparing a plan for restructuring the new business line as well as terminating employees. Businesses restructure all or part of their layout many times during their existence, so this issue arises a lot.

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Issue: Targa Company is restructuring its business line, as part of restructuring the company considers relocation of a manufacturing operation from its present location to a new geographic area. Relocation includes terminating certain employees.

Therefore, a question of how the incurred costs should be reported according to FASB Codification arises.

Targa Co. provides one-time termination benefit to its employees (Benefits provided to current employees that are involuntarily terminated under the terms of a one-time benefit arrangement), as stated in **FASB Section 420-10-50-1**:

All of the following information shall be disclosed in notes to financial statements that include the period in which an exit or disposal activity is initiated and any subsequent period until the activity is completed:

- a. A description of the exit or disposal activity, including the facts and circumstances leading to the expected activity and the expected completion date
- b. For each major type of cost associated with the activity (for example, one-time employee termination benefits, contract termination costs, and other associated costs), both of the following shall be disclosed:
 1. The total amount expected to be incurred in connection with the activity, the amount incurred in the period, and the cumulative amount incurred to date
 2. A reconciliation of the beginning and ending liability balances showing

separately the changes during the period attributable to costs incurred and charged to expense, costs paid or otherwise settled, and any adjustments to the liability with an explanation of the reason(s) why.

- c. The line item(s) in the income statement or the statement of activities in which the costs in (b) are aggregated
- d. For each reportable segment, as defined in Subtopic 280-10, the total amount of costs expected to be incurred in connection with the activity, the amount incurred in the period, and the cumulative amount incurred to date, net of any adjustments to the liability with an explanation of the reason(s) why
- e. If a liability for a cost associated with the activity is not recognized because fair value cannot be reasonably estimated, that fact and the reasons why.

Accounting for One-Time Employee Termination Benefits is suggested in **ASC 420-1025-4**:

An arrangement for one-time employee termination benefits exists at the date the plan of termination meets all of the following criteria and has been communicated to employees (referred to as the communication date):

- a. Management, having the authority to approve the action, commits to a plan of termination.
- b. The plan identifies the number of employees to be terminated, their job
- c. The plan establishes the terms of the benefit arrangement, including the benefits that employees will receive upon termination (including but not limited to cash

payments), in sufficient detail to enable employees to determine the type and amount of benefits they will receive if they are involuntarily terminated.

d. Actions required to complete the plan indicate that it is unlikely that

significant changes to the plan will be made or that the plan will be withdrawn.

Targa Co. should also account for nonretirement postemployment benefits offered as special termination benefits to employees and recognize it as a liability and a loss when the employees accept the offer and the amount can be reasonably estimated. An employer that offers, for a short period of time, special termination benefits to employees, shall not recognize a loss at the date the offer is made based on the estimated acceptance rate, as stated in **ASC 712-10-25-1**.

Relocation and training costs could be found in the Start-Up Costs Section **ASC 720-1555-6**:

A retail chain is constructing and opening two new stores. One will open in a territory in which the entity already has three stores operating. The other will open in a territory new to the entity. (Costs related to both openings are treated the same for purposes of this Subtopic.) All of the stores provide the same products and services. The following costs that might be incurred in conjunction with start-up activities are subject to the provisions of this Subtopic:

c. Training costs for employee

Following FASB guidance, we would account for training and renovation costs as Other Expenses.

Conclusion

Restructuring a business affects both management and employees, meaning no one is spared from the fallout. Management must decide the best plan of action that benefits the company the most as well as which employees need to be laid-off. The employees fear losing their jobs as a result of a downsize or merger. A restructure takes time and careful consideration in order to make the best decision for everyone involved.

All prior findings were collected from the FASB Codification website (referenced in the BIBLIOGRAPHY section on page 90).

CASE STUDY EIGHT: Merck & Co., Incorporated

This scenario offers an analysis of the Consolidated Financial Statements of Merck & Co., Incorporated, a global research company that focuses on pharmaceuticals. Merck & Co., Incorporated has subsidiaries that operate under and report back to Merck & Co., Incorporated. At the fiscal year-end, Merck & Co., Incorporated must prepare financial statements for all of its subsidiaries; these financial statements are all consolidated in the Consolidated Financial Statements. The financial statements utilized for this case are the Consolidated Income Statement, Consolidated Statement of Retained Earnings, Consolidated Statement of Comprehensive Income, Consolidated Balance Sheet, Consolidated Statement of Cash Flows, and Notes to the financial statements.

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Merck & Co., Inc. is a global research-driven pharmaceutical company that discovers, develops, manufactures and markets a broad range of products to improve human and animal health. Headquartered in New Jersey, the company employs 59,800 people worldwide, 11,700 of who are engaged in research activities. The company's shares are listed on the New York and Philadelphia Stock Exchanges. (Source: Company 2007 Form 10-K)

a.

i. How many common shares is Merck authorized to issue?

Merck & Co. authorized to issue 5,400,000,000 common shares as is evidenced on the Balance Sheet.

ii. How many common shares has Merck actually issued at December 31, 2007?

Merck & Co. issued 2,983,508,675 common shares, also found on the Balance Sheet.

iii. Reconcile the number of shares issued at December 31, 2007, to the dollar value of common stock reported on the balance sheet.

To reconcile the number of shares issued, dollar value of common stock is multiplied by number of shares issued at December 31, 2007 (fiscal year-end): 1 cent *

2,983,508,675 shares = 29.8 billion

iv. How many common shares are held in treasury at December 31, 2007?

811,005,791 Common Shares are held in treasury at December 31, 2007

v. How many common shares are outstanding at December 31, 2007?

811,005,791 treasury stock shares are subtracted from 2,983,508,675 shares issued to arrive at 2,172,502,884 common shares outstanding at December 31, 2007.

vi. At December 31, 2007, Merck's stock price closed at \$57.61 per share.

Calculate the total market capitalization of Merck on that day.

Total market capitalization of Merck & Co.: 2,983,508,675 shares issued in 2007

* \$57.61 = \$171,879, 934,766.75

c. Why do companies pay dividends on their common or ordinary shares? What normally happens to a company's share price when dividends are paid?

Companies pay dividends on their common or ordinary shares to show their current and potential investors that they can pay out dividends at a constant rate. Reliable dividend payouts also indicate that a company has financial strength and stability. However, once investors are accustomed to a constant payout, a year when the company is unable to payout dividends for whatever reasons can cause investor panic. The repercussion of this panic causes the market price to decline, whether temporarily or permanently.

When a company pays out dividends, the stock price decreases. This is referred to as the ex-dividend price.

d. In general, why do companies repurchase their own shares?

i Companies would repurchase their own stock:

(a) the stock is undervalued

(b) to increase EPS

(c) to “privatize” in order to thwart possible takeover attempt or to limit outside to control

(d) to provide stock for employee stock compensation plans

(e) to make a market in the stock by creating an artificial type demand

(f) to provide a tax efficient distribution to shareholders

e. This entry represents Merck’s common dividend activity for 2007:

Dr.

Dividends Pay 3.4 million

Cash 3307.3 billion

Cr.

RE 3310.7 billion

g.

i. Merck & Co. uses the Cost Method of accounting to account for its treasury stock transactions.

The Cost Method requires that companies record the stock being bought back (treasury stock) at the purchase cost.

ii. In reference to Note 11 of Merck’s financial statements, Merck & Co. repurchase 26.5 million shares on the open market during 2007.

iii. Merck & Co. paid 1,429.7 billion in total and \$53.95 per share. The repurchase of stock is a financing cash flow.

iv. Merck does not disclose treasury stock as an asset because treasury stock is a contra equity account. Treasury stock is not viewed as a benefit to the company because the company already owns the stock.

v. Ratio Analysis

(Figure 8.1)

| | 2007 | 2006 |
|-----------------------------|-----------------|-----------------|
| Dividends paid | \$3,307,300,000 | \$3,322,600,000 |
| Shares outstanding | 2,172,502,884 | 2,167,785,445 |
| Net income | 3,275,400,000 | 4,433,800,000 |
| Total assets | 48,350,700,000 | 44,569,800,000 |
| Operating cash flows | 6,999,200,000 | 6,765,200,000 |
| Year-end stock price | \$57.61 | 41.94 |

| | | |
|---|--------|--------|
| Dividends per share | \$1.52 | \$1.53 |
| Dividends yield (dividends per share to stock price) | 2.6% | 3.6% |
| Dividends payout (dividends to net income) | 101% | 74.9% |
| Dividends to total assets | 6.8% | 7.5% |
| Dividends to operating cash flows | 47.3% | 49.1% |

Conclusion

The methods used by a company to account for stock distributions affects how a company appears to investors. An equity investor might be looking for a consistent dividend payout that will earn them a greater return than a debt investment. An investor might also be looking for a firm that will hold their investment for a period of time before resale value increases. A company's decision to payout dividends or offer stock comes after a long period of deliberation between management members.

Overall, a company should choose a method that can be maintained far into the future as well as incentivizes investors.

CASE STUDY NINE: Xilinx, Incorporated

This scenario serves to explain a Human Resource decision that affects both management and employees. Companies routinely offer their employees stock as compensation instead of bonuses because of the future investment benefits given to both the company and its employees.

Xilinx, Inc. is a company that offers three different employee stock compensation plans. Discussed below are the reporting habits and reasoning behind each different plan.

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- a) A company will offer its employees the option to receive stock instead of cash. This is called a “stock option” and offers the employee the ability to buy common stock in the company any time within the vesture at the specified strike price. Stock options provide the employee with future profits on stock as well as stock in the company at a pre-set price that could benefit them in the future as long as the stock does not drop below the strike price before the vesture ends.
- b) RSUs offer the employee a cash option and a guaranteed value at the end of vesture whereas stock options are either distributed as common stock at the strike price, are expired, or become completely worthless. Stock options derive their value from the difference of the strike price and the market price while RSUs derive their value from the value of the share. RSUs offer an incentive to complete the requirements in order to receive the value whereas stock options could lose their incentive in the long-run. The duration of the incentive can affect employees in different ways: a company would offer both types of programs to employees because some employees might take the cash option offered by the RSUs or the stock offered by the stock option. Also, the different values given to each compensation plan decide how much incentive the employee has to complete the requirements before the vesture date.
- c)
- I. grant date: the date at which the company proclaims the activity to its shareholders
 - II. exercise price: (or strike price) the price at which an underlying security can be purchased or sold

- III. vesting period: the time that an employee must wait in order to be able to exercise employee stock options (the time over which the service is performed)
 - IV. expiration date: the date on which the contract expires (in the US this date is usually the third Friday of the contract month)
 - V. options/ RSUs granted: grant the employee the right to purchase a certain number of shares of the company's stock at a predetermined price (the total number of stocks a company puts up for the employee stock option program)
 - VI. options exercised: the stock options that employees purchase at the exercise price
 - VII. options/ RSUs forfeited or cancelled: the stock options that employees do not purchase within their vesture; these stocks are removed from the additional paid-in capital- stock options account and are added to the paid-in capital- expired stock options account.
- d) Under the Company's Employee Stock Purchase Plan, qualified employees can obtain a 24-month purchase right to purchase Xilinx's common stock at the end of each six-month exercise period. There is a limit to participation that each employee can take in this plan: participation is limited to 15% of the employee's annual earnings up to a maximum of \$21 thousand in a calendar year. The purchase price of the stock is 85% of the lower of the fair market value at the beginning of the 24-month offering period or at the end of each six-month exercise period. This offers the employee incentive to continually increase stock

price in order to gain the most benefit at the end of each period because of the value placed on the stock by the plan. This differs from the stock option and RSU plans because it has an extremely short vesture in addition to a discounted stock price. The ESPP also offers a specific, long-run incentive to increase stock price as opposed to achieving another type of performance goal.

e) Xilinx adjusted stock-based compensation on a quarterly basis for changes to the estimate of expected equity award forfeitures based on actual forfeiture experience. The company is required to measure the cost of all employee equity awards that are expected to be exercised based on the grant-date fair value of those awards and to record the cost of the compensation expense over the period during which the employee is required to perform any service in exchange for the award. The unvested portion is required to remain outstanding. Xilinx follows all GAAP requirements pertaining to stock-based compensation.

f)

I. \$77,862

II. This expense is recorded in “Cost of revenues,” “Research and Development,” and “Selling, general, and administrative” expenses. These three different expense accounts are debited to record the different types of employees receiving the stock compensation. This accurately places the expense in the correct account.

III. The expense is seen in the stock based compensation section under the operating activities. The expense is added back to operations.

IV. The income tax expense is seen over the entire vesture period. This accurately allocates the expense to the time period over which the service is being performed.

| | | |
|--|--------------------|--------|
| V. Cost of Goods Sold | 6,356 | |
| Research and Development Expense | 37,937 | |
| Selling, General, and Administrative Expense | 33,569 | |
| | APIC-Stock Option | 77,862 |
| Deferred Tax Asset | 22,1376 | |
| | Income Tax Payable | 22,137 |

g) Skip

h) Skip

i)

I. The article says that stock options are rapidly declining as a form of employee compensation. The article also says that restricted shares are increasing in popularity. Companies are starting to trend away from stock options because of the recent accounting change that forces them to account for stock options as an expense against income. Companies also agree that accounting for restricted shares is much simpler than accounting for stock options. Companies appreciate that they can issue less restricted

shares for the same value as an issuance of more stock options. Employees tend to like restricted stock more than stock options because stock options could become worthless depending on the price of the stock. Restricted shares have a guaranteed value to the employee.

- II. The table on page 62 of Xilinx's footnotes shows a constant decline in the number of stock options granted. On March 31, 2012, only 92 options were granted as opposed to the 2,345 options that were granted on April 3, 2010. The table on page 63 of Xilinx's footnotes shows a steady increase in the number of restricted shares granted. On April 3, 2010, only 2,043 were granted, while on March 31, 2012, 3,018 were granted. Both of these tables support the trend that companies and employees are moving away from stock options and towards restricted stock.

Conclusion

Including stock compensation plans to reward employees instead of cash is a smart investment decision that offers constant returns as opposed to a lump sum of cash at present time. As the trends show, companies are moving away from stock options and towards restricted stock because of the value guaranteed by restricted stock.

Nevertheless, it is important for a company to offer a wide range of compensation options to cater to as many employees as possible.

CASE STUDY TEN: Bier Haus

This scenario explains the five-step model of revenue recognition. The five steps to this process are included below:

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

Bier Haus offers different transactional situations and how to account for each situation when recording revenue by using the five-step model.

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On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study.

Part I:

1. Skip

2.

- a. Step One: (Identify the contract with the customer) The bartender takes the student's order for a large plastic cup of beer and tells him it will cost \$5. The student hands the bartender \$5.
- b. Step Two: (Identify the performance obligations in the contract) The bartender must give the student the cup of beer and the student must pay the bartender \$5.
- c. Step Three: (Determine the transaction price) The bartender tells the student the cup of beer is \$5. The student agrees by giving the bartender \$5.
- d. Step Four: (Allocate the transaction price to the performance obligations in the contract) The student will give the bartender \$5 in return for the cup of beer at the current time.
- e. Step Five: (Recognize revenue with the entity satisfies a performance obligation) The bartender recognizes revenue when the student takes the cup of beer and gives him \$5. The student recognizes revenue when his cup is filled with beer.

| | | | |
|-------------|----------------|---|---|
| 3. Student: | Beer Inventory | 5 | |
| | Cash | | 5 |
| Bartender: | Cash | 5 | |
| | Sales Revenue | | 5 |

Part II:

1.

2.

- a. Step One: (Identify the contract with the customer) The student gives the bartender \$7 for the beer and the mug and the bartender gives the student a full mug of beer. The student receives a discount for purchasing the beer and the mug together.
- b. Step Two: (Identify the performance obligations in the contract) The bartender will give the student beer in a mug in exchange for the transaction price of \$7.
- c. Step Three: (Determine the transaction price) The student gets a \$1 discount for using the Ole Miss mug instead of buying the beer for \$5 and the mug for \$3. The student only pays \$7 for the combined purchase.
- d. Step Four: (Allocate the transaction price to the performance obligations in the contract) In return for the \$7, the bartender fills the student's mug up with beer.
- e. Step Five: (Recognize revenue with the entity satisfies a performance obligation) The bartender recognizes revenue when he fills the student's mug with beer and the student hands him \$7. The student recognizes revenue when his mug is filled with beer.

| | | |
|-------------|--------------------|---|
| 3. Student: | Beer Inventory | 5 |
| | Mug Inventory | 3 |
| | Discount | 1 |
| | Cash | 7 |
| Bartender: | Cash | 7 |
| | Sales Revenue | 7 |
| | Cost of Goods Sold | 8 |
| | Beer Inventory | 5 |
| | Mug Inventory | 3 |

Part III:

- 1.
2.
 - a. Step One: (Identify the contract with the customer) The student buys a cup of beer and is given a coupon for the redemption of two pretzels at a later date. The bartender will give the customer beer today and will validate and honor the coupon for two pretzels at a later date.
 - b. Step Two: (Identify the performance obligations in the contract) The student pays the bartender \$7 for a cup of beer and a coupon for two pretzels at a later date. The bartender gives the student a cup of beer now and acknowledges a coupon to give the student two pretzels at a later date.
 - c. Step Three: (Determine the transaction price) The student pays the bartender \$7 today for \$5 of service right now and \$2 of service at a later

date. The student receives a discount because the coupons for two pretzels normally sell for \$3.50.

- d. Step Four: (Allocate the transaction price to the performance obligations in the contract) \$5 of the \$7 transaction price is performed at the current date. The remaining \$2 will be performed at a later date when the student redeems the coupon for two pretzels.
- e. Step Five: (Recognize revenue with the entity satisfies a performance obligation) The bartender will recognize revenue for the beer when he fills the student's cup. The bartender will recognize revenue for the pretzels when the coupon is redeemed and the pretzels are given to the student. The student will recognize revenue when he receives the beer today and when he receives the pretzels at a later date.

| | | | |
|-------------|--------------------|------|------|
| 3. Student: | Beer Inventory | 5 | |
| | Coupon | 3.50 | |
| | Discount | | 1.50 |
| | Cash | | 7 |
| Bartender: | Cash | 7 | |
| | Discount | 1.50 | |
| | Unearned Revenue | 3.50 | |
| | Sales Revenue | 5 | |
| | Cost of Goods Sold | 8.50 | |
| | Beer Inventory | 5 | |
| | Coupon Inventory | 3.50 | |

Part IV:

1.

2.

- a. Step One: (Identify the contract with the customer) The student presents the coupon and receives the two pretzels he paid for previously. The bartender validates the coupon and gives the student the two pretzels.
- b. Step Two: (Identify the performance obligations in the contract) The bartender owes the student two pretzels for redeeming his coupon from an earlier date at the current date. The student must hand over his coupon in exchange for the two pretzels.
- c. Step Three: (Determine the transaction price) The coupon was previously purchased for \$2. This is a discount from the usual \$3.50 charge for coupons. The \$3.50 is a discount from the usual charge of \$2 per pretzels. No cash is exchanged in the transaction to redeem the coupon.
- d. Step Four: (Allocate the transaction price to the performance obligations in the contract) The coupon has a value of \$2 to the student even though Bier Haus usually sells the coupons for pretzels for \$3.50. The pretzels given to the student at the time he redeemed the coupon have a value of \$2 to the student and a value of \$4 to the bartender. The bartender satisfies his obligation to give the student two pretzels at the current date.
- e. Step Five: (Recognize revenue with the entity satisfies a performance obligation) The student recognizes revenue when he receives the two

pretzels. The bartender recognizes revenue for the service performed in satisfying the coupon.

| | | | |
|-------------|--------------------|------|------|
| 3. Student: | Pretzel Inventory | 2 | |
| | Discount | 1.50 | |
| | Coupon | | 3.50 |
| Bartender: | Unearned Revenue | 3.50 | |
| | Discount | 0.50 | |
| | Sales Revenue | | 4 |
| | Cost of Goods Sold | 4 | |
| | Inventory | | 4 |

Conclusion

The five-step model of revenue recognition is a new standard set by the FASB to assist companies in correctly reporting revenue. Accurate reporting decreases audit misstatements as well as tax errors. This new standard is a finalization of the revenue recognition process.

CASE STUDY ELEVEN: ZAGG, Incorporated

This scenario serves to explain the difference between permanent and temporary accounts for tax accounting. A permanent account is a balance sheet account such as assets and liabilities. A temporary account is an income statement account such as revenues and expenses.

Zagg Inc. is a company that uses certain accounts for tax purposes and certain accounts for financial accounting purposes as seen in the temporary and permanent tax difference accounts. Discussed below are the definitions for words used in these scenarios and the practices used for each scenario.

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- a. Book income is the income reported within the financial statements of the taxable entity; taxable income normally is not aligned with book income reported within the financial statements. The Net Income (\$14,505) captures this notion for fiscal 2012. Book income differs from taxable income in that taxable income recognizes income when received and expenses when paid; additionally, some types of income are recognized for tax purposes that are not recognized in book income. Accurate financial statements show income regardless of whether it is taxable or not.
- b.
 - i. Permanent tax differences: a business transaction that is reported differently for financial and tax reporting purposes (Example: penalties and fines)
 - ii. Temporary tax differences: items that are recognized in one period for taxes, but in a different period for the books. (Example: depreciation method using straight-line method for the books versus accelerated method for tax purposes)
 - iii. Statutory tax rate: the legally imposed tax rate (35%)
 - iv. Effective tax rate: the average rate at which a corporation is taxed.
- c. Deferred income is included in total income tax expense because it is a liability that the company pays in the future. If the company does not include deferred taxes in the total income tax expense, its expenses are understated.
- d. Deferred income tax assets represent a situation where the company has overpaid taxes or taxes paid in advance on its balance sheet. An example of a deferred

income tax asset is when companies overpay warranty expenses but aren't allowed to make deductions on the warranty estimates so they end up paying the entire warranty expense. A deferred income tax occurs when the income tax payable is greater than the income tax expense on a balance sheet. An example of a deferred income tax liability is seen in the different methods used to record depreciation: the liability amount recorded on the books is usually different than what actually occurs.

- e. A deferred income tax valuation allowance arises when a company has a more than 50% probability that the company will not realize some portion of the asset. Changes in the allowance are recorded from within the continuing operations on the income statement. The allowance amount should be periodically re-assessed and may be changed based on tax laws.

f.

| | | |
|-----|------------------------|--------|
| i. | Income Tax Expense | 9,393 |
| | Net Deferred Tax Asset | 8,293 |
| | Income Tax Payable | 17,686 |
| ii. | Income Tax Expense | 9,393 |
| | DTA | 8,002 |
| | DTL | 291 |
| | Income Tax Payable | 17,686 |

DTA is increasing while the DTL is decreasing.

- iii. Effective Tax Rate = Tax Expense / Pre-Tax Income

$$X = 9,393 / 23,898$$

$X = 39.3\%$ (higher than the statutory rate)

The difference between the tax rates is the permanent tax difference.

- iv. The \$13,508,000 appears in the current deferred income tax assets (\$6,912) and in the deferred income tax assets (\$6,596).

Conclusion

Management should assess the impact of showing a permanent or temporary account on their books as they pertain to tax accounting. Deferred Tax Assets are positive items that management wants to see at the end of the year, while Deferred Tax Liabilities are negative items that management wants to avoid. Every single decision made for a company affects how and when the company is taxed. Taxes cannot be avoided, so the best practice a company can use is to be aware of how each decision affects every part of the company's financials.

CASE STUDY TWELVE: Build-A-Bear Workshop

This scenario serves to prove the difference between using a capital lease versus paying the full cost for an asset. Management must decide which option serves its company best, on both the asset and liability side of the purchase

Build-A-Bear is a company that uses leases to acquire assets as opposed to buying its assets outright. Discussed below are the alternative types of leases, the accounting for two types, as well as an observation of the results of using a specific type of lease.

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- a. Companies would rather lease assets than buy them because the company can use the assets and then return the assets when they no longer have use for them. This keeps the company from having completely worthless assets on its books. Additionally, the cost of leasing assets is less than the full cost of buying them. Ultimately, leasing assets allows the company to keep its assets moving when it doesn't need them and stationary when it does.
- b. An operating lease is a lease whose term is short compared to its useful life. It is commonly used to acquire equipment on a relatively short-term basis. A capital lease is a lease in which the lessor only finances the leased asset, and all other rights of ownership transfer to the lessee. This makes the asset the lessee's property. Also, a Lease Obligation is put onto the books of the leasing company and is capitalized over the service life of the lease. A sales type lease is classified as such when the fair value of the leased property at the start of the lease varies from its carrying amount, it involves real estate, and there is a transfer of ownership to the lessee by the end of the lease term.
- c. Accountants need to distinguish between the different types of leases because of the different ways the assets are presented in the books. Each lease addresses a different type of asset and a different transaction. For example: a capital lease has a liability to prove the lease whereas an operating lease has an expense to prove the lease.
- d.
 - i. This is an operating lease because the title does not transfer to the lessee. The lessee does not show a liability on its books.

| | | |
|------|-----------------------|---------|
| ii. | Lease Expense | 100,000 |
| | Cash | 100,000 |
| iii. | Year 1: No Entry | |
| | Year 2: Lease Expense | 125,000 |
| | Cash | 125,000 |
| | Year 3: Lease Expense | 125,000 |
| | Cash | 125,000 |
| | Year 4: Lease Expense | 125,000 |
| | Cash | 125,000 |
| | Year 5: Lease Expense | 125,000 |
| | Cash | 125,000 |

e.

- i. 45.9 million in base rent in 2009 plus 0.9 million in contingent rent 2009 totals 46.8 million in total rent expense.
- ii. The rent expense is found in the Selling, General, and Administrative Expense section.

f. Additional information: A company should capitalize the lease if four criteria exist: Is there a bargain purchase option at the end of the term? Does the title transfer at the end of the lease? Is the lease term greater than or equal to 75% of the useful life of the asset? Is the present value of the minimum lease payment greater than or equal to the asset's fair value?

- i. The Present Value of the future minimum lease payments is \$219,643.
- ii. PPE 219,643

| | | |
|------|----------------------|---------|
| | Lease Obligation | 219,643 |
| iii. | SKIP | |
| iv. | SKIP | |
| v. | Lease Obligation | 15,375 |
| | Interest Expense | 35,276 |
| | Cash | 50,651 |
| | Depreciation Expense | 27,455 |
| | Accumulated Dep. | 27,455 |

vi. SKIP

g. Build-A-Bear has incentive to structure its leases as operating leases because this method reduces the amount of liabilities (Lease Obligation) on the books. Less liabilities on the books means that the company is more liquid than if it had more debt to cover. It also appears better to investors who are concerned with the profitability of the company. Additionally, the company has the ability to obtain a lower interest rate on future debt it undertakes.

h.

i. The current ratio will decrease because the current liabilities will increase. The debt-to-equity ratio will increase because there is now a liability on the books that is capitalized over the useful life. The debt-to-assets ratio will increase as well because there is a long-term liability on the books through the capitalization of the lease. According to this Build-A-Bear case, the decision to capitalize leases does yield weaker liquidity, but there

is always an exception to this conclusion that depends on the company and its goals.

Figure 12.1 shows the Excel calculations used to find the Present Value of the lease payments.

| Year | Lease Payments | Present Value | Present Value of Payments |
|-------------|-----------------------|----------------------|----------------------------------|
| 2010 | 50651 | 0.9346 | 47337.38 |
| 2011 | 47107 | 0.8734 | 41145.08 |
| 2012 | 42345 | 0.8163 | 34566.13 |
| 2013 | 35469 | 0.7629 | 27059.13 |
| 2014 | 31319 | 0.7130 | 22330.01 |
| 2015 | 25228.66667 | 0.6663 | 16810.93 |
| 2016 | 25228.66667 | 0.6227 | 15711.15 |
| 2017 | 25228.66667 | 0.5820 | 14683.31 |
| | | | 219643.12 |

Conclusion

The decision about whether to report a lease as an operating or a capital lease or buying the asset outright has many different factors that come into play. The amount of debt a company wants to show on its books creates many implications, and management should take this into consideration. The alternative to recording a liability on the books with a capital lease is to record a perpetual expense throughout the life of the lease. Reporting a liability versus an expense depends on the type of business environment as well as the purpose of the business.

CONCLUSION

The research included in this thesis covers the majority of scenarios faced by public companies. As successfully as possible, I have learned about and concluded on almost everything I will face as a public accountant.

Although this past year of accounting has been the hardest on both my mental and physical health, I have grown immensely through it all. I understand now that I truly do love this profession and all of the challenges it presents. Now, one year removed from completing my thesis research and three months removed from finishing my internship with KPMG Birmingham, I know I am right where I should be. I hope I make my teachers proud as I run with the knowledge they've instilled in me.

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