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Financial Reporting: The Application of the Accounting Standards Codification

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FINANCIAL REPORTING: THE APPLICATION OF THE ACCOUNTING STANDARDS CODIFICATION

by
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Approved by

Advisor: Dr. Victoria Dickinson

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For my mom, Jennifer
Because of her continued support and love throughout my academic career, and also throughout my own life, she's helped me in more ways than anyone else and I could not have made it this far without her.

Abstract

KATHERINE CAMILLERI: Financial Reporting: The Application of the Accounting Standards Codification

The following presents a series of case studies in various areas of financial reporting. The purpose of these case studies is to further understand the concepts found in the Accounting Standards Codification and see how they can be applied in the real world. Each study focused on a different area of financial accounting and the appropriate ways to account for transactions in a company's four financial statements: the Income Statement, the Statement of Changes in Stockholders' Equity, the Balance Sheet, and the Statement of Cash Flows. To understand the situations and transactions each case study presented, I called upon the principles and ideas I have learned in my accounting courses as a student of the University of Mississippi Patterson School of Accountancy. With the information I gathered from doing research in the Codification, I was able to generate new knowledge on the accounting concepts deliberated in the respective case studies.

Through the research I performed on the various topics in financial reporting, I gained a clearer insight on how companies account for and report their day-to-day activities, while gaining a general awareness for how companies work. I have found that my enhanced knowledge of financial reporting topics and the business world has already propelled me further into becoming the strong business woman that I have been striving to grow into during my college career. I believe that because of my understanding of these different topics in financial reporting I learned how to use my critical thinking skills to construct solutions to contextualize large problems. My research process cultivated the ways I approached every problem I encountered while on my internship with the Big Four Accounting Firm KPMG. During my time as an intern in the international tax

department of the KPMG Houston office, I noticed myself reverting back to the ways of thinking that I used when advancing through the following case studies. With every new challenge as an intern, I found myself progressing intellectually as an accountant and business woman because of the analytical approach I used when problem-solving; the same approach I used to complete this thesis.

My hard skills also improved due to the extensive Excel work many of these case studies required. Before writing this thesis, I had not had much experience in Excel. Now I can say that I am extremely familiar with Excel and am comfortable learning new ways to filter and analyze data that is entered into the program. I found the improvement of my technical skills within Excel to be a huge factor as to why I easily transitioned into the work I was given on my internship. Having a solid knowledge base to build on during my internship was one of the most profitable things I learned from my time as an accounting student at the University of Mississippi.

In conclusion, the knowledge I have accumulated throughout writing this thesis will be substantial to my success in my future career as an accountant. The deeper understanding of accounting methods I received through the research I performed will be a great base for the concepts I will learn as a graduate student and for the concepts I will continue to build on as a young professional. The impact of conducting the research to write this thesis will assist me in achieving amazing heights in my professional career.

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Chapter 1 – Financial Statement Comparison
Executive Summary

This report provides an analysis and evaluation of the financial performances for two home heating companies during their first year of operations, 20X1. The two companies, Glenwood Heating, Inc. and Eads Heaters, Inc. are located in Glenwood Springs, Colorado and Eads, Colorado respectively. Glenwood Heating, Inc. and Eads Heaters, Inc. have identical operations during the year but have made different choices when applying generally accepted accounting principles (GAAP) in creating their companies' financial statements. The financial statements for both companies can be found in the following pages, along with the journal entries, trial balances, and further calculations, which can be found in the appendices.

Results of the data analyzed show that Glenwood Heating Inc. was overall more successful in its first year of operation. The recommendation for investment discussed in this report describes three main reasons for choosing Glenwood Heating, Inc. as a better investment than Eads Heaters, Inc. To provide this recommendation, I analyzed various factors included in the income statements, statements of changes in stockholders' equity, the balance sheets and the statements of cash flows for both companies. Glenwood Heating, Inc. had a higher net profit margin, a lower debt-to-asset ratio, and a higher earnings per share than its competitor Eads Heaters, Inc. Although both companies seem to have similar operations throughout year 20X1, the diverse methods in recording and preparing each company's financial statements help prove the many differences in finances in Glenwood Heating, Inc. and Eads Heating, Inc.

Financial Statements – Glenwood Heating, Inc.

Below are the four financial statements that describe the transactions for Glenwood Heating, Inc. for the year ended on December 31, 20X1. Upon first observation, the successes of Glenwood Heating, Inc. are quite apparent.

Glenwood Heating, Inc. Income Statement For the Year Ended on December 31, 20X1		
Revenues		
Sales		$398,500.00
Cost of Goods Sold		$177,000.00
Gross Profit		$221,500.00
Operating Expenses		
Rent Expense	$16,000.00	
Other Operating Expense	$34,200.00	
Operating Income		$171,300.00
Non Operating Expenses		
Bad Debt Expense	$994.00	
Depreciation Expense	$19,000.00	
Interest Expense	$27,650.00	
Provisions for Income Tax	$30,914.00	
Total Non Operating Expenses		$78,558.00
Net Income		**$92,742.00**

Glenwood Heating, Inc. Statement of Changes in Stockholders' Equity For the Year Ended on December 31, 20X1			
	Common Stock	Retained Earnings	Total Stockholders' Equity
Balance 1/1/20X1	$-	$-	$-
Issued Shares	$160,000.00	$-	$160,000.00
Net Income	$-	$92,742.00	$92,742.00
Dividends	$-	$23,200.00	$23,200.00
Balance 12/31/20X1	**$160,000.00**	**$69,542.00**	**$229,542.00**

Glenwood Heating, Inc.
Classified Balance Sheet
December 31, 20X1

Assets		**Liabilities**	
Current Assets		Accounts Payable	$26,440.00
Cash	$426.00	Interest Payable	$6,650.00
Accounts Receivable	$99,400.00	Notes Payable	$380,000.00
Allowance for Bad Debts	-$994.00	Lease Payable	$-
Inventory	$62,800.00	Total Liabilities	$413,090.00
Total Current Assets	$161,632.00		
Non-Current Assets		**Stockholders' Equity**	
Land	$70,000.00	Common Stock	$160,000.00
Building	$350,000.00	Retained Earnings	$69,542.00
Accumulated Depreciation, Building	-$10,000.00	Total Equity	$229,542.00
Equipment	$80,000.00		
Accumulated Depreciation, Equipment	-$9,000.00	**Total Liabilities and Equity**	**$642,632.00**
Leased Equipment	$-		
Accumulated Depreciation, Leased Equipment	$-		
Total Non-Current Assets	$481,000.00		
Total Assets	**$642,632.00**		

Glenwood Heating, Inc. Statement of Cash Flows For the Year Ended on December 31, 20X1		
Operating Activities		
Net Income		$92,742.00
Adjustments to Reconcile Net Income		
Depreciation Expense	$19,000.00	
Increase in Accounts Receivable	-$99,400.00	
Increase in Allowance for Bad Debts	$994.00	
Decrease in Inventory	-$62,800.00	
Increase in Accounts Payable	$26,440.00	
Increase in Interest Payable	$6,650.00	
Cash Flows from Operating		-$16,374.00
Investing Activities		
Purchase of Building	-$350,000.00	
Purchase of Land	-$70,000.00	
Purchase of Equipment	-$80,000.00	
Cash Flows from Investing		-$500,000.00
Financing Activities		
Line of Credit (Notes Payable)	$380,000.00	
Sale of Common Stock	$160,000.00	
Dividends	-$23,200.00	
Cash Flows from Financing		$516,800.00
Beginning Cash Balance		$-
Net Cash Flow		$426.00
Ending Cash Balance		**$426.00**

Financial Statements – Eads Heaters, Inc.

Below are the four financial statements that describe the transactions for Eads Heaters, Inc. for the year ended on December 31, 20X1. Like Glenwood Heating, Inc., Eads Heaters, Inc. shows clear signs of success. Upon further analysis presented in my financial recommendation, it will become more evident that Glenwood Heating, Inc. is much more successful in the home heating units industry in its first year of operations than its competitor Eads Heaters, Inc.

Eads Heaters, Inc. Income Statement For the Year Ended on December 31, 20X1		
Revenues		
Sales		$398,500.00
Cost of Goods Sold		$188,800.00
Gross Profit		$209,700.00
Operating Expenses		
Rent Expense	$-	
Other Operating Expense	$34,200.00	
Operating Income		$175,500.00
Non Operating Expenses		
Bad Debt Expense	$4,970.00	
Depreciation Expense	$41,500.00	
Interest Expense	$35,010.00	
Provisions for Income Tax	$23,505.00	
Total Non Operating Expenses		$104,985.00
Net Income		**$70,515.00**

Eads Heaters, Inc. Statement of Changes in Stockholders' Equity For the Year Ended on December 31, 20X1			
	Common Stock	Retained Earnings	Total Stockholders' Equity
Balance 1/1/20X1	$-	$-	$-
Issued Shares	$160,000.00	$-	$160,000.00
Net Income	$-	$70,515.00	$70,515.00
Dividends	$-	$23,200.00	$23,200.00
Balance 12/31/20X1	**$160,000.00**	**$47,315.00**	**$207,315.00**

Eads Heaters, Inc. Classified Balance Sheet December 31, 20X1			
Assets		**Liabilities**	
Current Assets		Accounts Payable	$26,440.00
Cash	$7,835.00	Interest Payable	$6,650.00
Accounts Receivable	$99,400.00	Notes Payable	$380,000.00
Allowance for Bad Debts	-$4,970.00	Lease Payable	$83,360.00
Inventory	$51,000.00	Total Liabilities	$496,450.00
Total Current Assets	$153,265.00		
Non-Current Assets		**Stockholders' Equity**	
Land	$70,000.00	Common Stock	$160,000.00
Building	$350,000.00	Retained Earnings	$47,315.00
Accumulated Depreciation, Building	-$10,000.00	Total Equity	$207,315.00
Equipment	$80,000.00		
Accumulated Depreciation, Equipment	-$20,000.00	**Total Liabilities and Equity**	**$703,765.00**
Leased Equipment	$92,000.00		
Accumulated Depreciation, Leased Equipment	-$11,500.00		
Total Non-Current Assets	$550,500.00		
Total Assets	**$703,765.00**		

Eads Heaters, Inc. Statement of Cash Flows For the Year Ended on December 31, 20X1		
Operating Activities		
Net Income		$70,515.00
Adjustments to Reconcile Net Income		
Depreciation Expense	$41,500.00	
Increase in Accounts Receivable	-$99,400.00	
Increase in Allowance for Bad Debts	$4,970.00	
Decrease in Inventory	-$51,000.00	
Increase in Accounts Payable	$26,440.00	
Increase in Interest Payable	$6,650.00	
Cash Flows from Operating		-$325.00
Investing Activities		
Purchase of Building	-$350,000.00	
Purchase of Land	-$70,000.00	
Purchase of Equipment	-$80,000.00	
Payment of Capital Lease	-$8,640.00	
Cash Flows from Investing		-$508,965.00
Financing Activities		
Line of Credit (Notes Payable)	$380,000.00	
Sale of Common Stock	$160,000.00	
Dividends	-$23,200.00	
Cash Flows from Financing		$516,800.00
Beginning Cash Balance		$-
Net Cash Flow		$7,835.00
Ending Cash Balance		**$7,835.00**

Financial Recommendation

After analyzing the financial statements of both companies, I believe that contributing to Glenwood Heating, Inc. would be a better investment than contributing to Eads Heaters, Inc. I came to this conclusion by evaluating three main factors that positively set Glenwood Heating, Inc. apart from their competition. The first factor was Glenwood's net profit margin, which can be found in the table below.

Company	Net Profit Margin
Glenwood Heating, Inc.	23.27%
Eads Heaters, Inc.	17.70%
**Net Profit Margin is found by dividing net income by Sales and multiplying by 100.*	

Glenwood Heating, Inc. has a higher net profit margin that equals about 23.27%. By investing in Glenwood, one would be supporting a more financially stable organization due to the fact that they conserve 5.57% more of their earnings than their competitor, Eads Heaters, Inc. Glenwood's higher net profit margin shows that they have the ability to manage their expenses and to produce profits from sales, more so than Eads.

Another factor that makes Glenwood Heating, Inc. more appealing to invest in is its debt-to-asset ratio, which appears in the table below.

Company	Debt-to-Asset Ratio
Glenwood Heating, Inc.	$0.64
Eads Heaters, Inc.	$0.71
**Debt-to-Asset Ratio is found by dividing total liabilities by total assets.*	

Eads Heaters, Inc. has a higher debt-to asset ratio because more of their money is involved in financing their assets, which translates to a higher amount of debt. This adds more risk to investment in Eads Heaters, Inc. because the future payout potential would not be guaranteed. Consequently, Glenwood Heating, Inc. seems to be a more stable choice to put my investment dollars. Glenwood has less money controlled by liabilities and, therefore, is financially more flexible. I recommend investing in a company with financial flexibility because it allows for adequate reactions to unforeseen expenses. A stable and liquid business also has a better opportunity to participate in unexpected investment opportunities, which could assist in the further development of the company.

Lastly, Glenwood Heating, Inc. is a more profitable company than Eads Heaters, Inc. This can be viewed when considering Glenwood and Eads' earnings per share, which are provided below.

Company	Earnings Per Share
Glenwood Heating, Inc.	$0.58
Eads Heaters, Inc.	$0.44
**Earnings Per Share is found by dividing net income by number of shares.*	

Glenwood's shares are worth $0.14 more per share than Eads' shares which proves that the company is more profitable than Eads. Although fourteen cents does not seem like a significant amount, in the course of time this divide between the companies could grow larger. Also, having a higher earnings per share grants Glenwood the capability to choose to pay dividends. With a higher potential for paying dividends, Glenwood is a more desirable company in the eyes of investors.

In summary, I believe that both Glenwood Heating, Inc. and Eads Heaters, Inc. were successful during their first year of operation. Due to further research and analysis, Glenwood Heating, Inc. is a better investment after year 20X1 because it is more financially stable and flexible than the competing company Eads Heaters, Inc.

Chapter 2 – Income Statement Presentation
Executive Summary

This report provides an analysis of the information for the income statement of our client Totz, an SEC registrant, during its year ended January 31, 2016. Totz is a company that manufactures and sells appealing, high quality children's clothing. Their stores attract many customers with their loud and colorful décor and environment. It is significant to recognize that Totz has its year end on the Saturday nearest to January 31. For the last three years of operation, Totz's operations ended on January 30, 2016; January 31, 2015; and January 25, 2014. Recently Totz introduced Doodlez, their new attraction of in-store art studios. This addition occurred in the third quarter of the fiscal year 2015. Doodlez provides many services for customers including painting, pottery, and drawing classes.

The following report presents the results my team and I found through the investigation of the operations of Totz and the different parts of Totz's income statement. We have included recommendations to determine the appropriate income statement presentation for the company's most recent year of operations. Additionally, we have provided support for our recommendations found in the report below from the Accounting Standards Codification issued by the Financial Accounting Standards Board or the FASB.

Income Statement Presentation Analysis

Net Sales

My team and I believe that the revenues for both Totz and Doodlez are listed as separate line items of the income statement under the operating income section as part of the company's sales. The Codification under ASC-225-10-S99-2-b describes why the revenues from products sold by Totz and the revenues from services provided by Doodlez are both featured separately under the operating income segment of the income statement. The authoritative guidance says,

> 1. If income is derived from more than one of the sub captions described under § 210.5–03.1, each class which is not more than 10 percent of the sum of the items may be combined with another class. If these items are combined, related costs and expenses as described under § 210.5–03.2 shall be combined in the same manner.
>
> 1. Net sales and gross revenues. State separately:
>
> (a) Net sales of tangible products (gross sales less discounts, returns and allowances),
>
> (b) operating revenues of public utilities or others;
>
> (c) income from rentals;
>
> (d) revenues from services; and
>
> (e) other revenues. (FASB Accounting Standards Codification)

Furthermore, Doodlez, being a subsidiary of Totz, needs to have a separate line item for the revenues of its services because Doodlez accounts for more than ten percent of its parent company's net sales. This detail fosters more proof as to why my team's recommendation of individual revenue calculations for Totz and Doodlez on the income statement.

In addition to making this classification on Totz's income statement, my team and I believe that it would be valuable to make a comparative income statement to provide comparisons between the different years of Totz's sales. Due to the variations in revenues between years 2014, 2015, and 2016, it would be helpful to have a comparative income statement to organize this information. Moreover, it would be essential to record in the notes to financial statements that the in-store art studio, Doodlez, was introduced as an addition to Totz in the third quarter of the fiscal year 2015, which would cause a significant change in the company's net sales.

Gross Profit

According to the FASB Codification, gross profit, or net sales less cost of sales, is recorded as an independent item of operating income included in the income statement. ASC 360-20-55-14 states that, "Gross profit is presented as a separate item of revenue on the income statement when it is recognized as earned." Additionally, a company's cost of sales is treated as two separate items when both tangible goods are sold and services are sold by a single company. The FASB Codification provides information regarding when a company's cost of sales is split into different amounts on the income statement in the following quote from ASC 225-10-S99-2-b,

> 2. Costs and expenses applicable to sales and revenues.
>
> State separately the amount of
>
> > (a) cost of tangible goods sold,
> >
> > (b) operating expenses of public utilities or others,

(c) expenses applicable to rental income,

(d) cost of services, and

(e) expenses applicable to other revenues.

> Merchandising organizations, both wholesale and retail, may include occupancy and buying costs under caption 2(a). Amounts of costs and expenses incurred from transactions with related parties shall be disclosed as required under § 210.4–08(k). (FASB Accounting Standards Codification)

Lastly, depreciation is not included in the amounts for cost of sales for Totz. Because depreciation is excluded from cost of sales, a note describing this practice is necessary. ASC 225-10-S99-8 states,

> The following is the text of SAB Topic 11.B, Depreciation and Depletion Excluded from Cost of Sales. Facts: Company B excludes depreciation and depletion from cost of sales in its income statement. Question: How should this exclusion be disclosed? Interpretive Response: If cost of sales or operating expenses exclude charges for depreciation, depletion and amortization of property, plant and equipment, the description of the line item should read somewhat as follows:
>
> Cost of goods sold (exclusive of items shown separately below)" or "Cost of goods sold (exclusive of depreciation shown separately below)." To avoid placing undue emphasis on "cash flow," depreciation, depletion and amortization should not be positioned in the income

> statement in a manner which results in reporting a figure for income before depreciation. (FASB Accounting Standards Codification)

It is important to note in this case that depreciation is not included in cost of sales because depreciation will be featured later on as a non-operating expense on the income statement. If this is done, the additional inclusion of depreciation with cost of sales would cause gross profit to be incorrect and understated in Totz's situation.

Gain on Sale of Corporate Headquarters

Totz relocated its corporate headquarters, sold its abandoned headquarters building, and realized a gain of $1.7 million on the sale of the building. This gain would be presented as a part of non-operating income on Totz's income statement. The relocation of a business's headquarters may be thought of as an extraordinary activity for a business, but it cannot be labeled as such under the non-operating income section on the income statement. Such an activity happens often with expanding businesses like Totz. Therefore, the gain on the sale of Totz's corporate headquarters could have been foreseeable and viewed as a usual occurrence for a business growing in size comparable to Totz. ASC 225-20-45-4 declares,

> Certain gains and losses shall not be reported as extraordinary items (except as indicated in the following paragraph) because they are usual in nature or may be expected to recur as a consequence of customary and continuing business activities. Examples include all of the following:
>
> a. Write-down or write-off of receivables, inventories, equipment leased to others, deferred research and development costs, or other intangible assets

> b. Gains or losses from exchange or translation of foreign currencies, including those relating to major devaluations and revaluations
>
> c. Gains or losses on disposal of a component of an entity
>
> d. Other gains or losses from sale or abandonment of property, plant, or equipment used in the business
>
> e. Effects of a strike, including those against competitors and major suppliers
>
> f. Adjustment of accruals on long-term contracts. (FASB Accounting Standards Codification)

Therefore, the gain Totz experienced from the sale of their corporate headquarters building would not be listed as an extraordinary gain, but as an item under Totz' non-operating income.

Class Action Settlement

The class action settlement that occurred between Totz and their fabric supplier granted Totz $2,700,000. According to ASC 225-20-45-16, one would include the effect of this infrequently occurring item under the non-operating income section of the income statement. The Codification states,

> A material event or transaction that is unusual in nature or occurs infrequently but not both, and therefore does not meet both 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. Gains or losses of a similar nature that are not individually material shall be aggregated. Such items shall not be reported on the face of the income statement net of income taxes or in any other manner that may imply that they are extraordinary items. Similarly, the EPS effects of those items shall not be presented on the face of the income statement. (FASB Accounting Standards Codification)

It is important to recognize this class action settlement in the non-operating income section of the income statement because it is considered as a transaction that is infrequent. A note needs to be made to adequately explain the gain to shareholders and potential investors. It is also significant to note that Totz's earnings per share will not be affected by the gain received from this settlement. Although it is an infrequent event, the class action settlement is still an essential part of Totz's 2016 income. Therefore, the proceeds of the $2.7 million legal case would be added to Totz's non-operating income of the income statement.

Chapter 3 – Cash Flow Classifications
Rocky Mountain Chocolate Factory Case Study

The following are the four financial statements for the Rocky Mountain Chocolate Factory case study.

Rocky Mountain Chocolate Factory, Inc.
Income Statement
For the Year Ended February 28, 2010

Revenues	
Sales	$22,944,017
Franchise and Royalty Fees	5,492,531
Total Revenue	28,436,548
Cost and Expenses	
Cost of Sales	14,910,622
Franchise Costs	1,499,477
Sales & Marketing	1,505,431
General and Administrative	2,422,147
Retail Operating	1,756,956
Depreciation and Amortization	698,580
Total Costs and Expenses	22,793,213
Operating Income	5,643,335
Other Revenues and Expenses	
Interest Income	27,210
Income Before 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
Diluted Effect of Employee Stock Options	197,521
Weighted Average Common Shares Outstanding, Assuming Dilution	6,210,238

Rocky Mountain Chocolate Factory, Inc.
Balance Sheet
February 28, 2010

Assets			Liabilities and Stockholders' Equity		
Current Assets			**Current Liabilities**		
Cash and Cash Equivalents	$	3,743,092	Accounts Payable	$	877,832
Accounts Receivables		4,427,526	Accrued Salaries and Wages		646,156
Notes Receivables, Current		91,059	Other Accrued Expenses		946,528
Inventories		3,281,447	Dividend Payable		602,694
Deferred Income Taxes		461,249	Deferred Income		220,938
Other Current Assets		220,163	Total Current Liabilities	$	3,294,148
Total Current Assets	$	12,224,536			
			Deferred Income Taxes	$	894,429
Property and Equipment, Net	$	5,186,709	Total Liabilities		4,188,577
Other Assets			**Stockholders' Equity**		
Notes Receivables, less Current Portion	$	263,650	Common Stock	$	180,808
Goodwill, net		1,046,944	Additional Paid-In-Capital		7,626,602
Intangible Assets, Net		110,025	Retained Earnings		6,923,927
Other Long Term Assets		88,050	Total Stockholders' Equity	$	14,731,337
Total Other Assets	$	1,508,669			
			Total Liabilities and Stockholders' Equity	**$**	**18,919,914**
Total Assets	**$**	**18,919,914**			

Rocky Mountain Chocolate Factory, Inc.
Statement of Retained Earnings
For Year Ended February 28, 2010

Retained Earnings, March 1, 2009	$5,751,017
Add: Net Income	3,580,077
Less: Dividends	2,407,167
Retained Earnings, February 28, 2010	**$6,923,927**

Statement of Cash Flows Classification

Transactions	Classification
1. Purchase Inventory	Operating
2. Incur Factory Wages	Operating
3. Sell Inventory for Cash	Operating
Sell Inventory on Account	Operating
4. Pay for Inventory	Operating
5. Collect Receivables	Operating
6. Incur SG&A (Cash)	Operating
Incur SG&A (Payable)	Operating
7. Pay Wages	Operating
8. Receive Franchise Fee	Operating
9. Purchase PPE	Investing
10. Dividends Declared and Paid	Financing
11. All Other Transactions	Operating, Investing, or Financing
Adjusting Transactions	
1. Adjust for Inventory Count	Operating
2. Record Depreciation	Operating
3. Wages Accrual	Operating
4. Consultant's Report	No Transaction Recorded on Cash Flows Statement

Chapter 4 – Internal Control Analysis

Ten potential fraud schemes are presented below. For each potential fraud scheme, an internal control is suggested to be put into action to prevent the fraud from taking place.

Potential Fraud Scheme 1:

Lucy is responsible for recording sales and preparing bank deposits. Given her autonomy with this process, Lucy could be underreporting sales and failing to deposit all of the money.

Internal Control:

In order to comply with separation of duties, one employee should be responsible for recording sales and another should be responsible for depositing money for those sales. This separation of responsibility makes it harder for one person to commit this type of fraud.

Potential Fraud Scheme 2:

The store that Kayla owns may have a petty cash fund that was established for smaller and miscellaneous expenses. If they do have a petty cash fund, employees may be incorrectly being reimbursed from the fund.

Internal Control:

In order to prevent this and ensure that petty cash fund disbursements are accurate, there should be access controls. Kayla should be the custodian. This means that she is the only person that can make payments. Also, Kayla, serving as the custodian, will need to collect receipts as a way of proving accurate disbursement.

Potential Fraud Scheme 3:

Kayla's store just implemented a new coupon discount program. Employees could be scanning coupons but charging the customers full price and then pocketing the difference.

Internal Control:

With this new program, there is limited evidence of processing the transaction. Clerks should have to enter all amounts into the system and keep the coupon with the receipt of the transaction.

<u>Potential Fraud Scheme 4:</u>

There is no evidence of a system to track the hours that each employee works.

Internal Control:

Kayla should implement a time card system to track exactly when each employee works.

<u>Potential Fraud Scheme 5:</u>

Kayla is responsible for the oversight of inventory, orders for new inventory, and payments of inventory. She could commit an act of fraud by falsifying orders, paying them to an external account, and expensing more inventory than actual to make up for the difference. This would reduce the income tax expense of the business by underreporting income while funneling cash out of the business.

Internal Control:

A separate employee should be responsible for inventory orders and payment of inventory orders. This separation of responsibility would prevent one person from autonomously falsifying orders to be paid to external accounts.

<u>Potential Fraud Scheme 6:</u>

Kayla has full custody of assets, and she also does the record keeping.

Internal Control:

Kayla should not be handling so much responsibility within the business since she is the owner of the company. Someone else should be helping with or taking over this area.

<u>Potential Fraud Scheme 7:</u>

Kayla and Lucy both have access to the accounting system, with Kayla handling all accounting functions and Lucy recording sales data and preparing bank deposits.

Internal Control:

This is an issue because Lucy and Kayla can both access records, which could lead to small changes to the sales records by Lucy without Kayla realizing it. Thought separation of duties is important, it is also important for the information to be valid and consistent.

<u>Potential Fraud Scheme 8:</u>

There is only one credit card machine for both cash registers.

Internal Control:

There is no way of knowing which employee is responsible for the credit card sale. There should be a credit card machine for each register so that credit card transactions can be allocated to the correct employee.

<u>Potential Fraud Scheme 9:</u>

There is no mention of a security system.

Internal Control:

If a security system was put in place, complete with cameras, then employees would be monitored at all times.

Potential Fraud Scheme 10:

Each employee has full authority to enter each type of transaction, meaning that they could change previous transactions.

Internal Control:

Kaya, as the owner, should be the only person with full authority. All other employees should have limited authority that allows them to only record transactions that are directly related to the sales process.

Chapter 5 – Inventory Impairment
Inventory Analysis Information

1. The costs expected in the raw materials inventory are costs of direct and indirect materials used in the production of the goods. The costs involved in the work-in-process inventory include the costs of direct materials, direct labor, and the factory overhead for all of the products that are still going through the manufacturing process. Finished goods inventory costs include all of the expenses used in the production of the good, including direct materials, direct labor and factory overhead.
2. The inventories are net of an estimated allowance for obsolete or unmarketable inventory.
3. a. This account appears as a contra asset on the company's balance sheet.
   b. The gross amount of inventory at the end of 2011 is \$243,870. The gross amount of inventory at the end of 2012 is \$223,362. (*See Appendix A for calculations.*)
   c. The full amount of the reserve for obsolete inventory is attributable to the finished goods inventory held by the company.
4. Journal entries:

12/31/2012	Cost of Goods Sold	13,348	
	Allowance for Obsolete & Unmarketable Inventory		13,348
12/31/2012	Allowance for Obsolete & Unmarketable Inventory	11,628	
	Inventories		11,628

5.

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

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

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

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

Cost of Goods Sold	
$0	
572,549	
13,348	
$585,897	

6. Inventory Turnover Ratio for 2011: 2.29

   Inventory Turnover Ratio for 2012: 2.63

   (*See Appendix B for calculations.*)

7. Inventory Holding Period for 2011: 159.39 or approximately 160 days

   Inventory Holding Period for 2012: 138.78 or approximately 139 days

   (*See Appendix C for calculations.*)

   The inventory holding period for 2011 was about 160 days, while the inventory holding period for 2012 was about 139 days. This means that it takes the company 21 less days to manufacture and sell its inventory in the current year of 2012 than in the prior year of 2011. Therefore, the company is becoming more efficient in its inventory management as time continues.

8. The percentage of finished goods that the company estimated as obsolete in 2012 was 7.37%. (*See Appendix D for calculations.)*

As an investor, I would like to know additional information about the trend of the reserve for obsolete inventory. I want to know if this percentage of finished good being obsolete is consistent with the previous periods' percentages for this reserve. I would also like to know if there were measures that the company could take to reduce this percentage to ensure my investment is not being wasted or ill-used due to inventory problems.

Chapter 6 – Accounting for Property, Plant, & Equipment

(a) The FASB Statement of Concepts No. 6 states that an asset is an item that will bring a company some kind of future benefit. Assets can bring a benefit of cash or some other benefit in the future. Expenses are cash flows or the use of assets out of the company that occur because of the operations within the company. An expense is capitalized when it has the value of the asset. Costs are expensed when it it maintains or repairs the asset and a future benefit is going to be provided.

(b) After a cost is capitalized, the cost becomes depreciated over time until it meets its salvage value. It becomes a depreciation expense on the income statement and depreciation is also accounted for on the balance sheet as a contra asset called accumulated depreciation. The income statement balance will decrease as depreciation grows. The asset section on the balance sheet will also decrease as accumulated depreciation grows over time due to it being a contra asset.

(c) These line costs are changes paid to local telephone networks to complete calls. The entry below is the entry that WorldCom documented for the line costs.

Line Costs (expense)	14,739,000,000	
Cash		14,739,000,000

(d) The types of costs that were improperly capitalized at WorldCom were line costs. They wrongfully capitalized these line costs that were paid to local telephone networks to complete calls. These costs should have been documented as expenses and should not have been capitalized. By making this incorrect entry, WorldCom was able to avoid having a loss on their financial statements and actually make it seem like a profit was being made. The improperly capitalized line costs do not meet the definition of an asset that I have provided above in part (a).

(e) PP&E (asset) 3,055,000,000

Line Costs (expense) 3,055,000,000

The PP&E appears on the asset section of the balance sheet. The Line Costs would be found under the 'capital expenditures' section under the investing activities part on the cash flows statement.

(f)

Improperly Capitalized Amounts for 2001	Years	Quarter	Depreciation Expense
$771,000,000	22	1	$35,045,454.55
$610,000,000	22	3/4	$20,795,454.55
$743,000,000	22	1/2	$16,886,363.64
$931,000,000	22	1/4	$10,579,545.45
$3,055,000,000			**$83,306,818.18**

Depreciation Expense 83,306,818.18

Accumulated Depreciation 83,306,818.18

(g) Partial Income Statement for WorldCom:

Income before taxes, as reported	$2,393,000,000
Add: depreciation for	83,306,818.18
Deduct: line costs that were improperly capitalized	-3,055,000,000.00
Loss before taxes, restated	-578,693,181.82
Income tax benefit	202,542,613.64
Minority interest	35,000,000.00
Net loss, restated	**-$341,150,568.18**

This net loss of $341,150,568.18 is material for WorldCom.

Chapter 7 – Restructuring Analysis
Executive Summary

This report provides an analysis of the restructuring of Targa Co.'s Armor Track line in accordance with U.S. GAAP. Targa Co. is a fitness equipment and technologies company looking to make significant improvements to their business. With this in mind, Targa's management is considering relocating its manufacturing operation which would require the termination of about 125 engineering, facility management, and operational management employees at its facility in Brooklyn Park, Minnesota. This plan of reducing the Brooklyn Park workforce by about 10% is estimated to occur by January 31, 20X2.

The following report presents the results my team and I found through the investigation of Targa's restructuring plan, specifically centered on how Targa should account for employee benefits and retraining and relocation costs. We have included recommendations to determine the appropriate financial statement presentation for the company's year ended December 31, 20X1. Additionally, we have provided support for our recommendations found in the report below from the Accounting Standards Codification issued by the Financial Accounting Standards Board, or FASB.

Employee Benefits

My team and I believe that the one-time, nonvoluntary termination employee benefit plan be recognized as a liability and also as a loss on Targa's financial statements. The total cost of the benefits the terminated employees will receive should be represented as a liability. Additionally, the amount of the lump-sum payments and the present value of any foreseeable future payments should be included on the company's statements as a loss. ASC-712-10-25-2 states the following,

> An employer that provides contractual termination benefits shall recognize a liability and a loss when it is probable that employees will be entitled to benefits and the amount can be reasonably estimated. The cost of termination benefits recognized as a liability and a loss shall include the amount of any lump-sum payments and the present value of any expected future payments.

Furthermore, we recommend that the one-time termination employee benefits that Targa is offering its employees be accounted for on the financial statements as of and for the year ended December 31, 20X1. This will occur due to the completion of all of the requirements found in the Codification under ASC-420-10-25-4 on the communication date of December 27, 20X1. The authoritative guidance says,

> 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 classifications or functions and their locations, and the expected completion date.
>
> c. The plan establishes the terms of the benefit arrangement, including the benefits that employees will receive upon termination

(including but not limited to cash payments), in sufficient detail to enable employees to determine the type and amount of benefits they will receive if they are involuntarily terminated.

d. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn

Within the restructuring plan, the employees are required to continue to work until they are terminated in order to gain the termination benefits which are also discussed further in ASC-420-10-25-9.

Retraining & Recollection Costs

My team and I recommend that the relocation cost and the staff training costs be expensed as other associated costs on Targa's financial statements. The explanation of this recommendation can be found in FASB. ASC-420-10-25-14 reports,

> Other costs associated with an exit or disposal activity include, but are not limited to, costs to consolidate or close facilities and relocate employees.

These entries will not appear on Targa's financial statements as of and for the year ended December 31, 20X1, but actually on the statements for the following year ended on December 31, 20X2. The Codification elaborates on the reasoning for these entries for year 20X2 in ASC-420-10-25-15. The authoritative guidance declares,

> The liability shall not be recognized before it is incurred, even if the costs are incremental to other operating costs and will be incurred as a direct result of a plan. A liability for other costs associated with an exit or disposal activity shall be recognized in the period in which the liability is

incurred (generally, when goods or services associated with the activity are received).

Because of this statement, the costs of relocation and retraining will be expensed as they incur in 20X2. We recommend this in order for Targa Co. to appropriately account for the restructuring of their business line in full accordance with U.S. GAAP.

Chapter 8 – Shareholders' Equity Report
Executive Summary

Merck & Co., Inc. is an international pharmaceutical company that is headquartered in New Jersey. The company employs approximately 59,800 people all over the world. Merck sells a plethora of products that work to improve human and animal health. Merck has shares listed on the New York and Philadelphia Stock Exchanges. This report interprets Merck & Co., Inc.'s shareholders' equity disclosures and describes the company's actions with its own common shares on the open market.

Shareholders' Equity Report

a)

i. Merck is authorized to issue 5,400,000,000 common shares.

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

iii. 2,983,508,675 common shares issued multiplied by the par value of $0.01 equals $29,835,086.75.

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

v. 2,172,502,884 common shares are outstanding at December 31, 2007.

vi. The total market capitalization of Merck on December 31, 2007 is 2,172,502,884 common shares outstanding multiplied but market price per share of $57.61 which equals $125,157,891,147.24.

c) Companies pay dividends on their common or ordinary shares for multiple reasons. A company paying out dividends could imply that their company is not experiencing aggressive growth which could be a bad sign. Normally, a company's share price decreases when dividends are paid.

d) In general, companies repurchase their own shares because it decreases the chances of a hostile takeover. A company repurchasing their own shares also raises the price of the shares. The company could also use the repurchased stock to increase cash flow later when they resell the shares.

e) The following entry is made to summarize Merck's common dividend activity for 2007.

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

g)

i. Merck uses the cost method to account for its treasury stock transactions.

ii. Merck repurchased 26,500,000 shares on the open market during 2007.

iii. Merck paid $1,429,700,000 in total and $53.95 per share, on average, to buy back its stock during 2007. This represents a financing type of cash flow.

iv. Merck does not disclose its treasury stock as an asset because treasury stock is not an asset. Treasury stock is not classified as an asset because a company cannot earn future economic benefit with treasury stock.

i)

Merck ($)	2007	2006
Dividends Paid	3,307,300,000	3,322,600,000
Shares Outstanding	2,172,502,884	2,167,785,445
Net Income	3,275,400,000	4,433,800,000
Total Assets	48,350,700,000	44,569,800,000
Operating Cash Flows	6,999,200,000	6,765,200,000
Year-End Stock Price	$57.61	$41.94
Dividends Per Share	$1.52	$1.53
Dividend Yield (dividends per share to stock price)	2.64%	3.65%
Dividend Payout (dividends to net income)	1.0097	0.7494
Dividends To Total Assets	0.0684	0.0745
Dividends To Operating Cash Flows	0.4725	0.4911

The price per share of dividends decreased by only one cent from 2006 to 2007. The dividend yield decreased by about one percent in 2007. This due to the significantly higher stock price at year-end in 2007. The dividend payout for 2007 is a little bit larger than in 2006 due to the amounts of net income and dividends paid in 2007 being closer in relation to the 2006 amounts. The dividends to total assets and dividends to operating cash flows ratios for 2006 and 2007 remain relatively close in amounts.

Chapter 9 – Stock-Based Compensation
Executive Summary

Xilinx, Inc. is an international company that was founded in 1984 that designs, develops, and markets compete programmable logic solutions. The company sells its solutions to electronic equipment manufacturers all over the world. Xilinx sells a plethora of products including advanced integrated circuits, software design tools, printed circuit boards, intellectual property cores, design services, customer training, field engineering and technical support. This report interprets information regarding Xilinx, Inc.'s stock-based compensation.

Stock-Based Compensation Report

A. Xilinx, Inc. offers equity incentive plans to employees, consultants, and non-employee directors of the Company. The Company measures out the cost of the employee equity awards and gives them the opportunity to be awarded for their service with stock options. Stock options give the employee the right to purchase a share of common stock at a pre-set price over a certain period of time. These stock options give employees the incentive to perform as well-trained employees, consultants, and non-employee directors and influences employees to take interest in the well-being of the Company. Offering stock options is an incentive for these employees to perform well, and hopefully results in high performance as a business.

B. Restricted stock units have many advantages. Stock options can become worthless, while restricted stock never becomes completely worthless. Stock options provide some long-term incentive to employees but mainly a large shortterm incentive. Restricted stock better aligns employee incentives with a company's incentives by providing more of a long-term perspective. A company might offer both types of programs to employees because for restricted stock shares, if an employee leaves prior to vesting, the employee loses the shares of restricted stock and they are returned to the company.

C. The grant date of stock options is the date the employee receives the options. The exercise price is the preset price of the shares. The vesting period is the amount of time that must pass before the employee receiving the stock options can exercise the options. If the employee does not exercise their stock options by the time of the expiration date, the option expires and becomes worthless. When a stock option is granted to an employee, the employee has the choice to buy shares of the company's stock at a predetermined price for a certain period of time. When an employee exercises a stock option, they purchase stock at the preset price, or the exercise price, not at the current price of the stock at the time of the purchase. Unvested shares are considered to have been forfeited or cancelled.

D. With Xilinx's employee stock purchase plan, eligible employees can gain the right to purchase Xilinx's common stock at the end of each six-month exercise period. Under this plan, the employee's can gain this right to purchase stock for twenty-four months. This plan provides the Xilinx employees incentives to purchase the Company's common stock at the end of each exercise period. The purchase price of the stock is 85% of the lower of the fair market value unlike the employee stock option and RSU plans stock prices, which are 100% of the fair market value of the stock on the date of grant.

E. Xilinx accounts for employee stock option activity by recording the cost of all employee equity awards that are expected to be exercised on the grant date at fair value and uses the compensation expense account to make this entry. All cash flows recognized from the excess tax benefits are placed on the statement of cash flows under financing activities. Lastly, Xilinx uses the straight-line attribution method to record the stock-based compensation costs over the service period of the awards.

F. i. The total expense (before income taxes) Xilinx reports for stock-based compensation in 2013 is $77,862.

ii. Xilinx includes this expense on the Income Statement under Operating Expenses. The stock-based compensation in 2013 is recorded separately as Research and Development, Selling, General and Administrative, and Cost of Revenues.

iii. The 2013 expense affects the statement of cash flows by increasing the amount of the net cash provided by operating activities. The amount of the expense appears in the statement of cash flows under the Stock-based Compensation as $77,862.

iv. The income tax effects of Xilinx's 2013 stock-based compensation expense is treated as a prepaid account called Deferred Tax Asset. It decreases the amount of taxable income.

v. The following journal entries are used to record Xilinx's stock-based compensation expense:

Cost of Revenues	6,356	
Research & Development	37,937	
SG & A	33,569	
APIC – Stock Option		77,862
Deferred Tax Asset	22,137	
Income Tax Payable		22,137

I. i. The article "Last Gasp for Stock Options?" discusses the trend of restricted stock awards replacing the use of employee stock options as a form of employee compensation. Companies find using restricted stock awards as more attractive because they provide employees with a greater incentive to reach performance goals with a form of compensation that is a less powerful wealth generator than stock options. Some employees may like stock options better than restricted stock awards because there is a chance for a larger reward. On the contrary, other employees may enjoy restricted stock awards more because there is more stability and safety with this type of compensation.

ii. The table on page 62 that depicts the amount of stock options granted from April 3, 2010 to March 30, 2013 definitely follows the trend of decreasing amount of stock options granted over the years described in the article from The Wall Street Journal. Furthermore, the table of Xilinx's RSU activity shown on page 63 also agrees with the article's predictions about the upcoming trends in stock-based compensation. Xilinx granted significantly more restricted stock in 2013 than they did in the year 2010.

Chapter 10 – Revenue Recognition

Part I:

Step 1: Identify the Contract with the Customer

The contract the customer and the bartender enter allows for the customer to receive beer in a large plastic cup in exchange for money.

Step 2: Identify the Performance Obligations in the Contract

The performance obligation the bartender has to fulfill is he has to provide the customer with a large plastic cup of beer. The performance obligation the customer has to fulfill is giving the bartender five dollars for the cup of beer.

Step 3: Determine the Transaction Price

The transaction price for the beer is five dollars.

Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract

There is only one performance obligation so the full payment of five dollars is allocated to the cost of the cup of beer.

Step 5: Recognize Revenue when the Entity Satisfies a Performance Obligation

Revenue is recognized almost instantaneously, when the cup of beer is given to the customer.

Journal Entry:

Cash	5.00	
Sales Revenue		5.00

Part II:

Step 1: Identify the Contract with the Customer

The contract the customer and the bartender enter allows for the customer to purchase a refillable Ole Miss thermal beer mug full of beer for a discounted price in exchange for money.

Step 2: Identify the Performance Obligations in the Contract

The performance obligation is that the bartender must give the customer both the Ole Miss thermal beer mug and the beer in exchange for the customer's money.

Step 3: Determine the Transaction Price

The entire transaction price for the beer and the mug is seven dollars.

Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract

The prices for both the beer and the mug were allocated using the standalone prices for the beer and the mug separately. The price for the beer was $5.00 and the price for the mug was $3.00. The two items' prices were allocated as shown below:

($5/$8) * $7 = $4.38 Beer

($3/$8) * $7 = $2.62 Mug

Step 5: Recognize Revenue when the Entity Satisfies a Performance Obligation

Revenue is recognized almost instantaneously, when the Ole Miss thermal beer mug full of beer is given to the customer.

Journal Entry:

Cash	7.00	
Sales Revenue – Beer		4.38
Sales Revenue – Mug		2.62

Part III:

Step 1: Identify the Contract with the Customer

The contract the customer and the bartender enter allows for the customer to receive beer in his beer mug and a coupon for two pretzels in exchange for money. The bartender must give the customer two pretzels when the coupon is redeemed.

Step 2: Identify the Performance Obligations in the Contract

The customer has satisfied his performance obligation by paying for both the pretzel coupon and the large beer. The bartender's performance obligation is to provide the customer with the beer now and two pretzels once the customer redeems the coupon. The performance obligation for the pretzels cannot be completed until the pretzels are redeemed with the coupon.

Step 3: Determine the Transaction Price

The transaction price is seven dollars.

Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract

The prices for both the beer and the coupon for two pretzels were allocated using the standalone prices for the beer and the coupon separately. The price for the beer was $5.00 and the price for the coupon was $3.50. The two items' prices were allocated as shown below:

$$(\$5/\$8.50) * \$7 = \$4.12 \text{ Beer}$$

$$(\$3.50/\$8.50) * \$7 = \$2.88 \text{ Coupon}$$

Step 5: Recognize Revenue when the Entity Satisfies a Performance Obligation

The revenue from the sale of beer is recognized once the beer is given to the customer. The revenue for the pretzels will not be recognized until the coupon for the two pretzels is redeemed at a later date. The coupon will now be recognized as a liability, specifically as unearned revenue.

Journal Entry:

Cash	7.00	
Sales Revenue – Beer		4.12
Unearned Sales Revenue – Pretzel Coupon		2.88

Part IV:

Step 1: Identify the Contract with the Customer

The contract the customer and the bartender enter allows for the customer to receive two pretzels in exchange for the redemption of the coupon.

Step 2: Identify the Performance Obligations in the Contract

The performance obligation in the contract entails that the customer must sacrifice the coupon to the bartender. It also entails that the bartender must give the customer two pretzels in exchange for the coupon.

Step 3: Determine the Transaction Price

The transaction price is the pretzel coupon which holds the value of $2.88.

Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract

The transaction price for the coupon does not need to be allocated because it has already been accounted and allocated as unearned sales revenue at the price of $2.88. There is only one performance obligation with this coupon redemption and it is fully accounted for with the value of $2.88.

Step 5: Recognize Revenue when the Entity Satisfies a Performance Obligation

Revenue is recognized when the bartender gives the pretzels to the customer.

Journal Entry:

Unearned Sales Revenue – Pretzel Coupon	2.88	
Sales Revenue – Pretzel Coupon		2.88

Chapter 11 - Deferred Income Taxes
ZAGG Inc.'s Case Report

A. Book income can also be referred to as pretax financial income, or "income before taxes, income for financial reporting purposes, or income for book purposes" (Kieso 1054). $23,898,000 is the number in ZAGG's statement of operation that captures the book income for fiscal 2012. Book income is determined according to Generally Accepted Accounting Principles (GAAP), while taxable income is determined according to Internal Revenue Code (IRC). The difference between using GAAP and IRC can be seen in the affects these rules have on financial reporting and taxable income. Companies use the full accrual method for financial reporting to report revenues. Companies then use a modified cash basis for tax purposes.

B.

i. Permanent tax differences result from items when they "(1) enter into pretax financial income but never into taxable income, or (2) enter into taxable income but never into pretax financial income" (Kieso 1066). When a company purchases life insurance for their employees, permanent tax differences can be viewed.

ii. Temporary tax differences result in amounts that are taxable in coming years after the related assets are recovered. A deductible temporary difference is very similar in that once the related liabilities are settled, amounts are deductible in coming years. For example, different depreciation methods can show a temporary tax difference.

iii. Statutory tax rate is the tax rate imposed by the law. Thirty-five percent is the federal statutory tax rate in this case.

iv. The effective tax rate is the rate of tax the corporation pays. The effective tax rate can be found by dividing the period's total income tax expense by the pretax financial income.

C. A company reports deferred income taxes as part of their total income tax expense because it allows investors and other viewers of the company's income statement to have a clearer and more accurate view of what is going on within the company. Including the deferred income taxes with the total income tax expense allows for others to view the increase in the deferred tax liability balance throughout the period.

D. A deferred income tax asset represents "the increases in taxes refundable (or saved) in future years as a result of deductible temporary differences existing at the end of the current year" (Kieso 1060). For example, if a company accrues a loss and related liability, it cannot deduct the loss for tax purposes until the liability is paid off. Because of this, a deferred tax asset can be recorded at the end of the current year due to the deduction that will be made in the future when the liability is paid off.

A deferred income tax 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" (Kieso 1056). If the current tax liability is smaller than the tax expense, the difference between the two would be the amount of the deferred tax liability. This temporary difference would cause an increase in future taxes payable.

E. A deferred income tax valuation allowance is a reduction in a deferred tax asset if, "It is more likely than not that it will not realize some portion or all of the deferred tax asset" (Kieso 1063). Essentially, this occurs when a company has evidence that presents with a likelihood of fifty percent or more that they will not be realizing a portion of an asset. The entry made for this allowance increases the income tax expense because the company believes they will not realize a favorable tax benefit for the portion of the asset not realized.

F.

i. The following information is the journal entry that ZAGG recorded for the income tax provision in fiscal 2012.

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

ii. The following information is the journal entry recorded for income tax and has been decomposed into its deferred income tax asset and deferred tax liability components.

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

iii. The effective tax rate is found by dividing tax expense by pre-tax income found on the Income Statement.

$$9{,}393{,}000 / 23{,}898{,}000 = .393 \sim 39.3\%$$

The effective tax rate is the percentage of the company's income that is paid in taxes. This means that the company is paying more that what the law has set as the tax rate.

iv. The net deferred income tax asset balance of $13,508,000 at December 31, 2012 appears on ZAGG's balance sheet under the Current Assets section labeled as Deferred Income Tax Assets with the balance of $6,912,000 and also under the Non-Current Assets section labeled as Deferred Income Tax Assets with the balance of $6,596,000.

Chapter 12 – Pensions
Build-A-Bear Workshop, Inc.'s Lease Case Report

A. Companies lease assets rather than buy them because it provides many genuine advantages over owning the asset. Leasing helps the lessee conserve cash and protects the lessee against inflation. Leasing an asset also reduces the risk of obsolescence. Flexibility is another advantage to leasing an asset over purchasing an asset. There are usually less restrictive provisions involved with leases than with other debt agreements. More often than not, leasing can be less costly than other forms of financing an asset. Tax benefits can be received through leasing, that can become a way for the lessee to achieve lower rental payments. Lastly, leasing an asset does not add debt to the balance sheet which is very advantageous to companies.

B. An operating lease is a lease that has a term shorter than the useful life of the asset. A capital lease must meet one or more of the following criteria:

    i. Transfers ownership of the property to the lessee
    ii. Contains a bargain-purchase option
    iii. Is equal to seventy-five percent or more of the estimated economic life of the leased property
    iv. The present value of the minimum lease payments equals or exceeds ninety percent of the fair value of the lease property.

A direct-financing lease is where the cost of the asset equals the fair value of the asset. Interest revenue is the only revenue earned on this type of lease. A sales-type lease is a lease where the cost of the asset does not equal the fair value of the asset. The lessor earns interest revenue on the asset as well as an additional profit.

C. Accountants distinguish between different types of leases because each individual lease provides different uses and is treated differently. One type of lease may benefit the lessor in different ways than another. This can occur when accounting for the differences in justifying leasing the asset, taking into account the credit standing of the lessee, the length of the lease, and the status of the residual value of the asset.

D.

i. This lease will be treated as an operating lease under the U.S. GAAP because the lease term is five years which is less than the twenty-five-year useful life of the asset. The lease does not follow the four pieces of criteria to be considered a capital lease.

ii. For Years 1-5

Lease Expense - rent	100,000	
Cash		100,000

iii. For Year 1

Lease Expense - rent	100,000	
Deferred Lease Expense		100,000

For Years 2-5

Lease Expense - rent	100,000	
Deferred Lease Expense	25,000	
Cash		125,000

E.

i. The amount of rent expense on operating leases in fiscal 2009 is $46.8 million.

ii. The rent expense appears on the company's income statement under the Selling, General, and Administrative Expenses section.

F.

i.

Period	Lease Payment	PV Factor	PV of Payment	Discount Rate
1	$50,651	0.9346	$47,337.38	7%
2	$47,107	0.8734	$41,145.08	
3	$42,345	0.8163	$34,566.13	
4	$35,469	0.7629	$27,059.13	
5	$31,319	0.7130	$22,330.01	
6	$25,229	0.6663	$16,811.15	
7	$25,229	0.6227	$15,711.35	
8	$25,229	0.5820	$14,683.51	
			$219,643.75	

ii.

Leased Asset - PP&E	219,644	
Lease Obligation		219,644

v.

Lease Obligation	35,276	
Interest Expense	15,375	
Cash		50,651
Depreciation Expense	27,455	
Accumulated Depreciation		27,455

G. If Build-A-Bear Workshop, Inc.'s management structures its leases as operating leases, then they show up as expenses on the income statement which lowers the net income of the company. With a lower net income, Build-A-Bear is able to pay less taxes with the operating lease structure in place.

H.

i. The decision to capitalize leases will not always yield weaker performance ratios. The capitalization of a lease can sometimes positively impact a company.

Appendix

Chapter 1: Glenwood Heating, Inc. – Schedules

Below are the schedules used to calculate values found in the general and adjusting journal entries for Glenwood Heating, Inc.

Schedule of Purchases			
Month	# of Units	Cost per Unit	Total Cost
January	40	$1,000.00	$40,000.00
March	60	$1,100.00	$66,000.00
June	20	$1,150.00	$23,000.00
September	62	$1,200.00	$74,400.00
October	28	$1,300.00	$36,400.00
			$239,800.00

Schedule of Annual Depreciation	
Building	$10,000.00
Equipment	$9,000.00
Total	**$19,000.00**

Schedule of Cost of Goods Sold		
Units	Cost per Unit	Total
40	$1,000.00	$40,000.00
60	$1,100.00	$66,000.00
20	$1,150.00	$23,000.00
40	$1,200.00	$48,000.00
		$177,000.00

Schedule of Net Income	
Revenues	$398,500.00
Expenses	-$274,844.00
Net Income	**$123,656.00**
Provision for Income Tax	$30,914.00

Eads Heaters, Inc. – Schedules

Below are the schedules used to calculate values found in the general and adjusting journal entries for Eads Heaters, Inc.

Schedule of Purchases			
Month	Units	Cost per Unit	Total Cost
January	40	$1,000.00	$40,000.00
March	60	$1,100.00	$66,000.00
June	20	$1,150.00	$23,000.00
September	62	$1,200.00	$74,400.00
October	28	$1,300.00	$36,400.00
			$239,800.00

Schedule of Annual Depreciation	
Building	$10,000.00
Equipment	$20,000.00
Total	**$30,000.00**

Schedule of Cost of Goods Sold		
Units	Cost per Unit	Total
28	$1,300.00	$36,400.00
62	$1,200.00	$74,400.00
20	$1,150.00	$23,000.00
50	$1,100.00	$55,000.00
		$188,800.00

Schedule of Net Income	
Revenues	$398,500.00
Expenses	$304,480.00
Net Income	**$94,020.00**
Provisions for Income Tax	$23,505.00

Chapter 5: Inventory Impairment

A. Gross Inventory

Calculation for 2011:

$233,070 + $10,800 = $243,870

Calculation for 2012:

$211,734 + $11,628 = $223,362

B. Inventory Turnover

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Sales}}{\text{Average Inventories, Net}}$$

Calculation for 2011: 2.29

$$= \frac{\$575{,}226}{\left(\frac{\$268{,}591 + \$233{,}070}{2}\right)}$$

Calculation for 2012: 2.63

$$= \frac{\$585{,}897}{\left(\frac{\$233{,}070 + \$211{,}734}{2}\right)}$$

C. Inventory Holding Period

$$\text{Inventory Holding Period} = \frac{\text{365 days}}{\text{Inventory Turnover Ratio}}$$

Calculation for 2011: 159.39 or 160 days

$$= \frac{\text{365 days}}{2.29}$$

Calculation for 2012: 138.78 or 139 days

$$= \frac{\text{365 days}}{2.63}$$

D. Obsolete Finished Goods

$$\text{Percentage of Obsolete Finished Goods} = \frac{\text{Inventory Reserve Provision}}{\text{Finished Goods Inventory + Inventory Reserve Provision}}$$

Calculation for 2012: 7.37%

$$= \frac{\$13{,}348}{\$167{,}646 + \$13{,}348}$$

Works Cited

"FASB Accounting Standards Codification®." *FASB Accounting Standards Codification®*, asc.fasb.org/.

Kieso, Donald E. *Intermediate Accounting*. S.l.: John Wiley, 2016. Print.