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A COMPILATION OF ANALYSES OF FINANCIAL REPORTING

by
Kellie Amanda Shannon

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

Oxford
May 2018

Approved by

____
Advisor: Professor Victoria Dickinson

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Reader: Dean Mark Wilder

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ABSTRACT

KELLIE AMANDA SHANNON: A Compilation of Analyses of Financial Reporting
(Under the direction of Victoria Dickinson)

The purpose of this paper is to explore financial reporting topics through twelve separate case studies. The following cases were completed over the course of a year in the independent study class Accy 420. The case studies provided the opportunity to explore accounting topics beyond the journal entries typically taught in accounting classes. In-class discussions and the Financial Accounting Standards Board (FASB) Accounting Standards Codification guided the development of the solutions to the twelve cases. For each case, I learned the applicable FASB guidance and the theory behind the appropriate accounting treatment. The case studies allowed me to explore topics ranging from potential fraud schemes to a new revenue recognition principle. The cases also provided the opportunity to develop Microsoft Excel and research skills. Through the knowledge gained from the completion of these studies, I am better equipped to think critically in my professional career.

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Case 1

Comparing Accounting Choices

September 7, 2016

Executive Summary

Glenwood Heating, Inc. and Eads Heaters, Inc. are two new companies who began selling home heating units at the beginning of the year 20X1. Though the companies engaged in the same transactions over the course of the year, the managers of each company made different accounting choices and estimates for adjusting entries at year end. These differences in estimates created differences in the companies' financial statements and led to a higher net income for Glenwood Heating, Inc. Thus, the financial statements suggest that Glenwood Heating, Inc. is the better company for debt or equity investment, but one must consider the effect of the estimates on future years' earnings.

Recording Basic Transactions (Part A)

The actual operations of Glenwood and Eads during 20X1 suggest that the two companies are on equal footing financially before the application of estimates in adjusting entries. Table 1-1 presents the companies' identical transactions during 20X1.

Recording Additional Transactions (Part B)

On December 31, 20X1, the managers of each company needed to estimate uncollectible accounts receivable, cost of goods sold, depreciation expense, rent for equipment, and a provision for income taxes. The managers followed generally accepted accounting principles (GAAP) in preparing their estimates, but GAAP still allows for flexibility. Thus, different accounting choices and estimates affect the amount of expense recorded in the financial statements. Table 1-2 and Table 1-3 present the additional entries for Glenwood Heating and Eads Heaters, respectively.

Table 1-1 Recording Basic Transactions of Glenwood and Eads

Transaction	Assets					
	Cash	Accounts Receivable	Inventory	Land	Building	Equipment
No. 1	160,000					
No. 2	400,000					
No. 3	(420,000)			70,000	350,000	
No. 4	(80,000)					80,000
No. 5			239,800			
No. 6		398,500				
No. 7	299,100	(299,100)				
No. 8	(213,360)					
No. 9	(41,000)					
No. 10	(34,200)					
No. 11	(23,200)					
No. 12						
Balances	$ 47,340	$ 99,400	$ 239,800	$ 70,000	$ 350,000	$ 80,000

Transaction	Liabilities			Stockholders' Equity	
	Accounts Payable	Interest Payable	Note Payable	Common Stock	Retained Earnings
No. 1				160,000	
No. 2			400,000		
No. 3					
No. 4					
No. 5	239,800				
No. 6					398,500
No. 7					
No. 8	(213,360)				
No. 9			(20,000)		(21,000)
No. 10					(34,200)
No. 11					(23,200)
No. 12		6,650			(6,650)
Balances	$ 26,440	$ 6,650	$ 380,000	$ 160,000	$ 313,450

Supporting Schedules

1. Transaction 5 Purchase of home heating units

Date	Jan. 10	Mar. 14	Jun. 1	Sep. 15	Oct. 30	Total
No. of units	40	60	20	62	28	
x Cost per unit	x $1,000	x $1,100	x $1,150	x $1,200	x $1,300	
Total	$40,000	$66,000	$23,000	$74,400	$36,400	239,800

2. Transaction 9 Principal payment plus nine months' interest
   $400,000 principal x 7% x 9/12 = $21,000 interest expense
3. Transaction 11 Dividends $7.25 per share x 3,200 shares = $23,200
4. Transaction 12 Accruing interest
   ($400,000 principal - $20,000) x 7% x 3/12 = $6,650 interest expense

Table 1-2 Additional Transactions for Glenwood Heating

	Assets								
Transaction	**Cash**	**Accounts Receivable**	**Allowance for Bad Debts**	**Inventory**	**Land**	**Building**	**A/D - Building**	**Equipment**	**A/D - Equipment**
Balances: Part A	47,340	99,400	-	239,800	70,000	350,000	-	80,000	-
Part B (1) Bad debts			994						
Part B (2) COGS				(177,000)					
Part B (3) Depreciation									
Building							10,000		
Equipment									9,000
Part (4) Equipment									
Rental payment	(16,000)								
Part (5) Income tax	(30,914)								
Balances	426	99,400	994	62,800	70,000	350,000	10,000	80,000	9,000

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

Supporting Schedules

1. Transaction 1B Recording accounts receivable uncollectible $99,400 x 1% = $994
2. Transaction 2B Calculating cost of goods sold through FIFO

No. of units	Cost per unit	COGS
40	$1,000	$40,000
60	$1,100	$66,000
20	$1,150	$23,000
40	$1,200	$48,000
160		$177,000

3. Transaction 3B Recording building and equipment depreciation
   Building depreciation: Straight-line, 30 year expected life, $50,000 salvage value
   ($350,000 - $50,000)/30 year = $10,000 depreciation expense
   Equipment depreciation: Straight-line, 8 year expected life, $8,000 salvage value
   ($80,000-$8,000)/8 year = $9,000 depreciation expense
4. Transaction 5B Provision for income taxes (25% of GAAP income)

Sales	$398,500
Cost of goods sold	(177,000)
Bad debt expense	(994)
Depreciation expense	(19,000)
Interest expense	(27,650)
Other operating	(34,200)
Rent expense	(16,000)
	$123,656 x 25% = $30,914

Table 1-3 Additional Transactions for Eads Heaters

	Assets										
Transaction	**Cash**	**Accounts Receivable**	**Allowance for Bad Debts**	**Inventory**	**Land**	**Building**	**A/D - Building**	**Equipment**	**A/D - Equipment**	**Leased Equipment**	**A/D – Leased Equip.**
Balances: Part A	47,340	99,400	-	239,800	70,000	350,000		80,000			
Part B (1) Bad debts			4,970								
Part B (2) COGS				(188,800)							
Part B (3) Depreciation											
Building							10,000				
Equipment									20,000		
Part (4) Equipment										92,000	11,500
Rental payment	(16,000)										
Part (5) Income tax	(23,505)										
Balances	7,835	99,400	4,970	51,000	70,000	350,000	10,000	80,000	20,000	92,000	11,500

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

Supporting Schedules

1. Transaction 1B Recording accounts receivable uncollectible $99,400 x 5% = $4,970
2. Transaction 2B

Transaction 2B	No. of units	Cost per unit	COGS
Calculating cost of goods sold through LIFO	28	$1,300	$36,400
	62	$1,200	$74,400
	20	$1,150	$23,000
	50	$1,100	$55,000
	160		$188,800

3. Transaction 3B Recording building and equipment depreciation
   Building Depreciation: Straight-line, 30 year expected life, $50,000 salvage
   ($350,000 - $50,000)/30 year = $10,000 depreciation expense
   Equipment Depreciation: Double-declining ($80,000/8 year expected life) x 2 = $20,000 depr.
4. Transaction 5B Provision for income taxes (25% of GAAP income)

Sales	$398,500	
Cost of goods sold	(188,800)	
Bad debt expense	(4,970)	
Depreciation expense	(41,500)	
Interest expense	(35,010)	
Other operating expenses	(34,200)	
	94,020	x 25% = $23,505
	$123,656	x 25% = $30,914

Analysis of Additional Transactions (Part B)

The different accounting choices and estimates used in the additional entries can be examined to explain their effects on the financial statements.

1. Bad Debt Expense – Glenwood Heating, Inc. estimates that one percent of ending accounts receivable will not be collected while Eads Heaters, Inc. uses a five percent estimate. By estimating a smaller percentage, Glenwood Heating, Inc. records less bad debt expense and thus has a higher income than Eads. Since 20X1 is the first year of operations for both companies, managers cannot rely on past years' measurements of uncollectible accounts receivable to determine a good estimate for 20X1. Thus, ambiguity exists as to which company has a more accurate estimate. However, one must note that Glenwood's low percentage leads to greater income in the current year while the higher estimate for Eads can be used to smooth earnings by reducing income in a financially good year.
2. Cost of Goods Sold – The manager of Glenwood Heating, Inc. chose to use FIFO (first-in, first-out) when estimating the cost of goods sold while Eads Heaters, Inc. opted to measure its inventory through LIFO (last-in, first-out). The use of FIFO allows the cost of inventory on the balance sheet to approximate current costs. However, the oldest costs are matched with current revenue when one uses FIFO, so net income may be distorted. Since the cost per home heating unit increased over the course of the year, LIFO creates a tax benefit and results in a lower income as items most recently purchased at a higher price are matched against revenues.

3. Depreciation Expense – The manager of Eads Heaters, Inc. chose to use double-declining balance to estimate the amount of depreciation expense for the company's delivery equipment. The double-declining method expenses more depreciation at the beginning of the expected life of the equipment than the straight-line method does. Thus, this depreciation choice causes Eads to subtract more expense from its earnings in 20X1 than Glenwood does. However, by recording greater depreciation expense currently, Eads will have less expense and thus more income in future years.
4. Rental Equipment – Glenwood Heating, Inc. chose to record $16,000 of rent expense in 20X1, so this expense reduces income. In contrast, Eads Heaters, Inc. capitalized the leased equipment. Capitalizing the equipment results in higher charges against income in the early years of the capital lease agreement as Eads must record the depreciation expense of the equipment as well as the interest expense on the lease payable. Thus, Eads will have a lower income and lower retained earnings than Glenwood has during the early years of the lease. The use of a capital lease also increases the amount of total assets and the amount of debt reported on the balance sheet.
5. Provision for income taxes – Both companies estimate the provision for income taxes to be 25 percent of their GAAP income. While the previous accounting choices lead Glenwood to have a higher income, Eads benefits from its accounting choices in regards to taxes. With a lower GAAP income, Eads experiences a lower tax burden.

Financial Statements

Glenwood Heating's income statement, statement of retained earnings, balance sheet, and statement of cash flows are presented in Table 1-4, Table 1-5, Table 1-6, and Table 1-7, respectively.

Table 1-4 Income Statement for Glenwood Heating

Glenwood Heating, Inc. Income Statement For the Year Ended December 31, 20X1		
Sales		$ 398,500
Cost of goods sold		177,000
Gross profit		221,500
Operating expenses		
Bad debt expense	$ 994	
Depreciation expense - building	10,000	
Depreciation expense - equipment	9,000	
Rent expense	16,000	
Other operating expenses	34,200	70,194
Income from operations		151,306
Other expenses and losses		
Interest expense		27,650
Income before income tax		123,656
Provision for income taxes		30,914
Net income		$ 92,742
Earnings per common share		$28.98

Table 1-5 Statement of Retained Earnings for Glenwood Heating

Glenwood Heating, Inc. Statement of Retained Earnings For the Year Ended December 31, 20X1	
Retained earnings, January 1	$ -
Add: Net income	92,742
Less: Cash dividends	23,200
Retained earnings, December 31	$ 69,542

Table 1-6 Balance Sheet for Glenwood Heating

Glenwood Heating, Inc. Balance Sheet December 31, 20X1			
Assets			
Current assets			
Cash		$ 426	
Accounts receivable	$ 99,400		
Less: Allowance for bad debts	994	98,406	
Inventory		62,800	
Total current assets			$ 161,632
Property, plant, and equipment			
Land		70,000	
Building	350,000		
Less: Accumulated depreciation	10,000	340,000	
Equipment	80,000		
Less: Accumulated depreciation	9,000	71,000	
Total property, plant, and equipment			481,000
Total assets			$ 642,632
Liabilities and Stockholders' Equity			
Current liabilities			
Accounts payable		$ 26,440	
Interest payable		6,650	
Current portion of long-term note payable		20,000	
Total current liabilities			$ 53,090
Long-term debt			
Twenty-year, 7% note payable			360,000
Total liabilities			$ 413,090
Stockholders' equity			
Paid in on capital stock			
Common - Authorized, issued, and outstanding, 3,200 shares of $50 par value		160,000	
Retained earnings		69,542	
Total stockholders' equity			229,542
Total liabilities and stockholders' equity			$ 642,632

Table 1-7 Statement of Cash Flows for Glenwood Heating

Glenwood Heating, Inc. Statement of Cash Flows For the Year Ended December 31, 20X1		
Cash flows from operating activities		
Net income		$ 92,742
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$ 19,000	
Increase in accounts receivable	(99,400)	
Increase in allowance for bad debts	994	
Increase in inventory	(62,800)	
Increase in accounts payable	26,440	
Increase in interest payable	6,650	(109,116)
Net cash used by operating activities		(16,374)
Cash flows from investing activities		
Purchase of land	(70,000)	
Purchase of building	(350,000)	
Purchase of equipment	(80,000)	
Net cash used by investing activities		(500,000)
Cash flows from financing activities		
Proceeds from long-term note	400,000	
Principal payment of long-term note	(20,000)	
Issuance of common stock	160,000	
Payment of cash dividends	(23,200)	
Net cash provided by financing activities		516,800
Net increase in cash		426
Cash, January 1, 20X1		-
Cash, December 31, 20X1		$ 426

The financial statements of Eads Heaters, Inc. are presented in Table 1-8, Table 1-9, Table 1-10, and Table 1-11.

Table 1-8 Income Statement for Eads Heaters

Eads Heaters, Inc. Income Statement For the Year Ended December 31, 20X1		
Sales		$ 398,500
Cost of goods sold		188,800
Gross profit		209,700
Operating expenses		
Bad debt expense	$ 4,970	
Depreciation expense - building	10,000	
Depreciation expense - equipment	20,000	
Depreciation expense - leased equipment	11,500	
Other operating expenses	34,200	80,670
Income from operations		129,030
Other expenses and losses		
Interest expense		35,010
Income before income tax		94,020
Provision for income taxes		23,505
Net income		$ 70,515
Earnings per common share		$22.04

Table 1-9 Statement of Retained Earnings for Eads Heaters

Eads Heaters, Inc. Statement of Retained Earnings For the Year Ended December 31, 20X1	
Retained earnings, January 1	$ -
Add: Net income	70,515
Less: Cash dividends	23,200
Retained earnings, December 31	$ 47,315

Table 1-10 Balance Sheet for Eads Heaters

Eads Heaters, Inc. Balance Sheet December 31, 20X1			
Assets			
Current assets			
Cash		$ 7,835	
Accounts receivable	$ 99,400		
Less: Allowance for bad debts	4,970	94,430	
Inventory		51,000	
Total current assets			$ 153,265
Property, plant, and equipment			
Land		70,000	
Building	350,000		
Less: Accumulated depreciation	10,000	340,000	
Equipment	80,000		
Less: Accumulated depreciation	20,000	60,000	
Leased equipment	92,000		
Less: Accumulated depreciation	11,500	80,500	
Total property, plant, and equipment			550,500
Total assets			$ 703,765
Liabilities and Stockholders' Equity			
Current liabilities			
Accounts payable		$ 26,440	
Interest payable		6,650	
Current portion of long-term note		20,000	
Current portion of lease payable		9,330	
Total current liabilities			$ 53,090
Long-term debt			
Twenty-year, 7% note payable			360,000
Lease payable			74,030
Total liabilities			496,450
Stockholders' equity			
Paid in on capital stock			
Common - Authorized, issued, and outstanding, 3,200 shares of $50 par value		160,000	
Retained earnings		47,315	
Total stockholders' equity			207,315
Total liabilities and stockholders' equity			$ 703,765

Table 1-11 Statement of Cash Flows for Eads Heaters

Eads Heaters, Inc. Statement of Cash Flows For the Year Ended December 31, 20X1		
Cash flows from operating activities		
Net income		$ 70,515
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$ 41,500	
Increase in accounts receivable	(99,400)	
Increase in allowance for bad debts	4,970	
Increase in inventory	(51,000)	
Increase in accounts payable	26,440	
Increase in interest payable	6,650	(70,840)
Net cash used by operating activities		(325)
Cash flows from investing activities		
Purchase of land	(70,000)	
Purchase of building	(350,000)	
Purchase of equipment	(80,000)	
Net cash used by investing activities		(500,000)
Cash flows from financing activities		
Proceeds from long-term note	400,000	
Principal payment of long-term note	(20,000)	
Issuance of common stock	160,000	
Principal payment of lease payable	(8,640)	
Payment of cash dividends	(23,200)	
Net cash provided by financing activities		508,160
Net increase in cash		7,835
Cash, January 1, 20X1		-
Cash, December 31, 20X1		$ 7,835

Supplemental Schedule of Noncash Investing and Financing Activities:
Capitalized leased equipment with present value of $92,000 with eight year, 8% lease liability

Conclusion

The financial statements reveal that Glenwood Heating, Inc. has a greater net income and more retained earnings than Eads Heaters, Inc. However, Glenwood has a smaller amount of total assets and a smaller cash balance than Eads. While these differences arise solely from differing accounting techniques and estimates, Glenwood Heating, Inc. is the better company for debt or equity investment. For instance, Glenwood Heating, Inc. has a smaller debt to assets ratio as calculated in Table 1-12, so Glenwood is better able to use its assets to cover the obligations of its long-term debt. In contrast, the lease payable creates a large future debt burden for Eads. Also, Glenwood's larger ending balance of retained earnings suggests that the company will be able to continue to pay dividends to investors. Because Glenwood's net income is higher, the company's profit margin calculated in Table 1-12 is also higher than the profit margin of Eads, so Glenwood will be the better investment if this trend continues. However, potential investors must note that Eads has already incurred greater expenses like depreciation expense and inventory cost that Glenwood must record in future years.

Table 1-12 Selected Ratios for Glenwood Heating and Eads Heaters

	Glenwood	Eads
Debt to assets ratio	$413,090/$642,632 = .643	$496,450/$703,765 = .705
Profit margin	$92,742/$398,500 = .233	$70,515/$398,500 = .177

Despite the indications that Glenwood is a better investment, investors and creditors must be aware that the estimates used in calculations may not be accurate due to lack of information during each company's first year. Moreover, each company's managers may have strategically made accounting decisions that would allow for earnings management.

Case 2

Analyzing Income Statement Presentation

September 21, 2016

Executive Summary

Totz is a high quality children's clothing company that manufactures its products and sells them in bright, colorful stores. During the third quarter of fiscal year 2015, Totz introduced Doodlez into its stores. Doodlez is an in-store art studio providing services through painting, pottery, and drawing classes. As a registrant of the Securities and Exchange Commission, Totz must file formal financial statements, including an income statement. In preparing the income statement, Totz faces decisions of how to present net sales, cost of sales, gross profit, a gain on a sale of its corporate headquarters, and proceeds from the settlement of a class action lawsuit.

Income Statement Presentation

The Financial Accounting Standards Board (FASB) establishes financial accounting and reporting standards for both public and private companies. The FASB seeks to ensure uniformity of accounting standards to aid users of financial statements. In addition, the Securities and Exchange Commission (SEC) controls the accounting practices and standards used by public companies, including registrants like Totz. To provide easy, simplified access to such standards, the FASB compiled all authoritative guidance in the Financial Accounting Standards Board Accounting Standards Codification. Using the standards provided in the Codification, Totz can determine the appropriate methods of presentation for each item in its income statement. Nevertheless, despite the guidelines provided in the Codification, some questions may still arise and will require the judgment of the preparer of the financial statements.

1. Net Sales

Totz manufactures and sells its clothing products and also provides services through Doodlez. Totz should present the income from these activities under the sales section of the income statement but must delineate between the different sources of income. ASC-225-10-S99-2 provides guidance for separating revenue between products and services. The "S" that precedes the section number indicates that the rule is actually part of authoritative content issued by the SEC, and the corresponding regulation S-X Rule 5-03 states that the following revenue accounts should be separated if they are greater than 10 percent of the sum of all revenues:

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.

In fiscal year 2016, net sales of $75.3 million from tangible clothing pieces and revenues of $11.2 million from Doodlez's services are each greater than 10 percent of the total revenue of $86.5 million, so the two types of revenue should be disclosed separately under the sales section of the 2016 income statement. In addition, Totz presents 2015 and 2016 amounts for net sales and cost of sales, so Totz should prepare comparative income statements. ASC 205-10-45-2 expresses desire for an income statement to be presented for one or more previous years in addition to the current year. The FASB explains, "The presentation of comparative financial statements in annual and other

reports enhances the usefulness of such reports and brings out more clearly the nature and trends of current changes affecting the entity" (ASC 205-10-45-1). To aid comparability, Totz should note the change in presentation style in fiscal year 2016 from previous years' presentations. For instance, in fiscal year 2015, net sales from products and the revenue from services were not both greater than 10 percent of total sales, so they would have been presented in one line item in fiscal 2015. According to ASC 205-10-45-3, amounts from previous periods shown for comparative purposes should be comparable with the figures shown in current statements, so Totz must revise the sales section of the 2015 comparative income statement to reflect 2016's separation of revenue.

2. Gross Profit

Gross profit is a subtotal on the income statement and reflects the calculation of net sales and gross revenues less cost of sales. Thus, the expenses incurred by Totz to acquire and produce inventory are part of the cost of sales section of the income statement. Since the sales section of the income statement differentiated between revenue from products and revenue from services, ASC-225-10-S99-2 requires that Totz's relevant expenses be separated between cost of tangible goods sold and cost of services. ASC-225-10-S99-8 also provides guidance for reporting depreciation with regards to cost of sales. While the SEC allows depreciation to be reported separately from cost of sales, Staff Accounting Bulletin Topic 11.B states that the line item should read, "Cost of goods sold (exclusive of items shown separately below)" or "Cost of goods sold (exclusive of depreciation shown separately below)." Within the cost of sales section, Totz is correct to include product costs, freight-in and import costs, and direct labor costs. ASC 330-10-30-1

explains that cost is the sum of expenditures incurred to bring an item to its current condition, so cost includes acquisition and production expenses. Thus, freight-in and import costs are included in cost of sales as acquisition costs, and direct labor and products costs are part of the manufacturing costs included on the income statement. However, Totz should not report a gross profit subtotal. ASC 225-10-S99-8 states that a company should not report a subtotal that excludes depreciation. Because the excluded depreciation is attributable to cost of sales, Totz should not report gross profit.

3. Gain on Sale of Corporate Headquarters

Totz relocated its corporate headquarters and sold the abandoned building for a gain of $1.7 million. Totz can easily eliminate extraordinary items and discontinued operations as possible classification choices for the gain. ASC 225-20-55-4 specifically states that gains and losses from sale or abandonment of property, plant, or equipment should not be reported as an extraordinary item because they are usual in nature or are expected to occur again. Moreover, Accounting Standards Update No. 2015-01 eliminated extraordinary items as a classification on the income statement effective for fiscal years beginning after December 15, 2015. The gain on the sale of corporate headquarters is also not considered a discontinued operation as described in ASC 205-20-45-1 since Totz is only disposing of a physical building and not a component of the actual operations of the business. This gain on the sale of the corporate headquarters should be considered a material gain and should be classified as part of operating income. ASC 605-10-S99-1 states that gains or losses from the sale of assets should be reported as other general expenses and that any material item should be stated separately. Furthermore, ASC 360-

10-45-5 states that “a gain or loss recognized on the sale of a long-lived asset (disposal group) that is not a component of an entity shall be included in income from continuing operations before income taxes in the income statement of a business entity. If a subtotal such as income from operations is presented, it shall include the amounts of those gains or losses.” Taken together, the guidance suggests that the gain from the sale of the corporate headquarters should be presented as operating income.

4. Class Action Settlement

Totz received a $2.7 million settlement in a lawsuit against one of its fabric suppliers in fiscal year 2016. Because the lawsuit was actually settled in fiscal 2016, Totz recognizes the proceeds from the settlement in the 2016 income statement, and the nature of the settlement payment may determine the proceeds’ treatment as a gain in the non-operating income section. Before the settlement was reached, the potential proceeds from the case were considered a gain contingency, which the FASB defines as “an existing condition, situation, or set of circumstances involving uncertainty as to possible gain to an entity that will ultimately be resolved when one or more future events occur or fail to occur” (ASC 450-10-20). The proceeds from the lawsuit were not recorded in fiscal year 2015 or any previous year because ASC 450-30-25-1 states that a gain contingency should not be shown in the financial statements since revenue might be recognized before it is actually realized. Thus, Totz records the $2.7 million in fiscal year 2016 when the settlement was reached. Totz will likely record at least part of the settlement’s proceeds as a material gain in the non-operating income section as ASC 225-10-S99-2 requires for miscellaneous income. However, Totz must consider the type of damages covered by the

settlement payment, and additional information may be needed. ASC 605-50-45-12 says that "cash consideration received by a customer from a vendor is presumed to be a reduction of the prices of the vendor's products or services and, therefore, shall be characterized as a reduction of cost of sales when recognized in the customer's income statement." If part of the payment is intended to be a return of Totz's past payments to its fabric supplier, the proceeds may be recorded as a reduction of expenses in the cost of sales section of the income statement.

Conclusion

The Financial Accounting Standards Board establishes standards that help Totz to determine appropriate classifications for its accounts in the income statement. As a registrant of the Securities and Exchange Commission, Totz is also subject to SEC requirements. The detailed rules provided in the Codification explain the correct presentation of income from product sales and services within the sales section of the income statement. After determining sales, Totz can subtract cost of sales but must not present a gross profit total. In addition, Totz will report the gain on the sale of its corporate headquarters as part of operating income. Further analysis is needed to determine the appropriate presentation of proceeds from a class action settlement. Through the guidance of accounting standards as well as the judgment of knowledgeable accountants, Totz can prepare an income statement that accurately reflects the company's operations.

Case 3

Preparing Financial Statements

October 5, 2016

Executive Summary

Rocky Mountain Chocolate Factory, Inc. is an international manufacturer of chocolate and a retailer with stores across the United States. As a publicly traded company, Rocky Mountain Chocolate Factory must prepare financial statements to be filed with the Securities and Exchange Commission. The preparation of financial statements requires a long process of activities, from recording the initial transactions to creating journal entries and trial balances. This process, more specifically, is referred to as the accounting cycle. This cycle consists of identifying financial transactions, recording journal entries, posting the entries to the general ledger, preparing an unadjusted trial balance, recording adjusting journal entries, preparing an adjusted trial balance, creating the financial statements, and recording closing entries. While the accounting cycle is a long process that occurs over the course of the year, a simple spreadsheet can summarize all of the activities of the accounting cycle. Table 3-1 presents a data sheet for Rocky Mountain's fiscal year 2010 transactions. The data sheet shows increases and decreases to Rocky Mountain's many balance sheet and income statement accounts. While the changes in each account for each transaction can be inferred from the data sheet, Table 3-2 provides a more formal presentation of the journal entries, including adjusting entries, for Rocky Mountain's fiscal year 2010 transactions. Table 3-3 presents the balances of Rocky Mountain's accounts prior to adjusting entries, and Table 3-4 displays the adjusted trial balance. From the adjusted trial balance, financial statements can be prepared. Table 3-5 shows Rocky Mountain's income statement, and the net income amount presented in the income statement is carried to the statement of retained earnings in Table 3-6. Finally, Table 3-7 presents the company's 2010 balance sheet.

Table 3-1 Rocky Mountain Chocolate Factory's Data Sheet

		Beginning balance (February 28, 2009)	1. Purchase inventory	2. Incur factory wages	3. Sell inventory for cash and on account	4. Pay for inventory	5. Collect receivables	6. Incur SG&A (cash and payable)	7. Pay wages	8. Receive franchise fee	9. Purchase PPE	10. Dividends declared and paid	11. All other transactions
Dr.	Cash and cash equivalents	1,253,947					4,100,000		(6,423,789)	125,000			790,224
	Accounts receivable	4,229,733											
	Notes receivable, current												91,059
	Inventories	4,064,611	7,500,000	6,000,000									
	Deferred income taxes	369,197											92,052
	Other	224,378											
	Property & Equipment, net	5,253,598									498,832		132,859
	Notes receivable, less current portion	124,452											139,198
	Goodwill, net	1,046,944											
	Intangible assets, net	183,135											
	Other	91,057											
Cr.	Accounts payable	1,074,643	7,500,000										503,189
	Accrued salaries and wages	423,789		6,000,000					(6,423,789)				
	Other accrued expenses	531,941						3,300,000					
	Dividend payable	598,986										3,709	
	Deferred income	142,000								125,000			
	Deferred income taxes	827,700											66,729
	Common stock	179,696											1,112
	Additional paid-in capital	7,311,280											315,322
	Retained earnings	5,751,017											
	Sales				22,000,000								944,017
	Franchise and royalty fees												5,492,531
Dr.	Cost of sales				14,000,000								693,786
	Franchise costs												1,499,477
	Sales & marketing							1,505,431					
	General and administrative							2,044,569					
	Retail operating							1,750,000					
	Depreciation and amortization												
	Interest income												
	Income Tax Expense												2,090,468
	A = L + OE + R - E												

Table 3-1 (continued)

		Unadjusted Trial Balance	12. Adjust for inventory count	13. Record depreciation	14. Wage accrual	15. Consultant's report	Pre-closing trial balance	16. Closing entry	Post-closing (ending balance)	Actual February 28, 2010 F/S figures
Dr.	Cash and cash equivalents	3,743,092					3,743,092		3,743,092	3,743,092
	Accounts receivable	4,427,526					4,427,526		4,427,526	4,427,526
	Notes receivable, current	91,059					91,059		91,059	91,059
	Inventories	3,498,283	(216,836)				3,281,447		3,281,447	3,281,447
	Deferred income taxes	461,249					461,249		461,249	461,249
	Other	220,163					220,163		220,163	220,163
	Property & Equipment, net	5,885,289		(698,580)			5,186,709		5,186,709	5,186,709
	Notes receivable, less current portion	263,650					263,650		263,650	263,650
	Goodwill, net	1,046,944					1,046,944		1,046,944	1,046,944
	Intangible assets, net	110,025					110,025		110,025	110,025
	Other	88,050					88,050		88,050	88,050
Cr.	Accounts payable	877,832					877,832		877,832	877,832
	Accrued salaries and wages	-			646,156		646,156		646,156	646,156
	Other accrued expenses	946,528					946,528		946,528	946,528
	Dividend payable	602,694					602,694		602,694	602,694
	Deferred income	220,938					220,938		220,938	220,938
	Deferred income taxes	894,429					894,429		894,429	894,429
	Common stock	180,808					180,808		180,808	180,808
	Additional paid-in capital	7,626,602					7,626,602		7,626,602	7,626,602
	Retained earnings	3,343,850					3,343,850	3,580,077	6,923,927	6,923,927
	Sales	22,944,017					22,944,017	(22,944,017)	-	22,944,017
	Franchise and royalty fees	5,492,531					5,492,531	(5,492,531)	-	5,492,531
Dr.	Cost of sales	14,693,786	216,836				14,910,622	(14,910,622)	-	14,910,622
	Franchise costs	1,499,477					1,499,477	(1,499,477)	-	1,499,477
	Sales & marketing	1,505,431					1,505,431	(1,505,431)	-	1,505,431
	General and administrative	1,782,947			639,200		2,422,147	(2,422,147)	-	2,422,147
	Retail operating	1,750,000			6,956		1,756,956	(1,756,956)	-	1,756,956
	Depreciation and amortization	-		698,580			698,580	(698,580)	-	698,580
	Interest income	(27,210)					(27,210)	27,210	-	(27,210)
	Income Tax Expense	2,090,468					2,090,468	(2,090,468)	-	2,090,468
	A = L + OE + R - E	-	-	-	-	-	-	-	-	(3,580,077)

Table 3-2 Rocky Mountain Chocolate Factory's Journal Entries

Transaction	Account Title	Debit	Credit
1)	Inventories	7,500,000	
	Accounts Payable		7,500,000
	to record purchase of raw material		
2)	Inventories	6,000,000	
	Accrued Salaries and Wages		6,000,000
	to record accrual of factory wages		
3)	Cash	17,000,000	
	Accounts Receivable	5,000,000	
	Sales		22,000,000
	to record sale of inventory		
	Cost of Sales	14,000,000	
	Inventories		14,000,000
	to record cost of inventory		
4)	Accounts Payable	8,200,000	
	Cash		8,200,000
	to record payment of accounts payable		
5)	Cash	4,100,000	
	Accounts Receivable		4,100,000
	to record collection of accounts receivable		
6)	Sales and Marketing Expenses	1,505,431	
	General and Administrative Expenses	2,044,569	
	Retail Operating Expenses	1,750,000	
	Cash		2,000,000
	Other Accrued Expenses		3,300,000
	to record incurrence of expenses		
7)	Accrued Salaries and Wages	6,423,789	
	Cash		6,423,789
	to record payment of accrued wages		
8)	Cash	125,000	
	Deferred Income		125,000
	to record receipt of franchise fees		
9)	Property and Equipment	498,832	
	Cash		498,832
	to record purchase of PPE		

Table 3-2 (continued)

Transaction	Account Title	Debit	Credit
10)	Retained Earnings	2,407,167	
	Dividends Payable		3,709
	Cash		2,403,458
	to record declaration and payment of dividends		
11)	Cash	790,224	
	Notes Receivable, Current	91,059	
	Deferred Income Taxes	92,052	
	Property and Equipment, Net	132,859	
	Notes Receivable, noncurrent portion	139,198	
	Other Accrued Expenses	2,885,413	
	Dividends Payable	1	
	Deferred Income	46,062	
	Cost of Sales	693,786	
	Franchise Costs	1,499,477	
	Income Tax Expense	2,090,468	
	Accounts Receivable		702,207
	Inventories		66,328
	Other Current Assets		4,215
	Intangible Assets, Net		73,110
	Other Assets		3,007
	Accounts Payable		503,189
	Deferred Income Taxes		66,729
	Common Stock		1,112
	Additional paid-in capital		315,322
	Sales		944,017
	Franchise and royalty fees		5,492,531
	General and administrative expense		261,622
	Interest Income		27,210
	to record net effect of various transactions		
12)	Cost of Sales	216,836	
	Inventories		216,836
	to adjust inventory to an ending physical count		
13)	Depreciation and Amortization Expense	698,580	
	Property and Equipment, Net		698,580
	to record depreciation and amortization of PPE		
14)	General and Administrative Expense	639,200	
	Retail Operating Expense	6,956	
	Accrued Salaries and Wages		646,156
	to accrue wages		
15)	No transaction		

Table 3-3 Rocky Mountain Chocolate Factory's Unadjusted Trial Balance

Rocky Mountain Chocolate Factory, Inc.
Unadjusted Trial Balance
February 28, 2010

Account title	**Debit**	**Credit**
Cash and cash equivalents	$ 3,743,092	
Accounts receivable	4,427,526	
Notes receivable, current	91,059	
Inventories	3,498,283	
Deferred income taxes	461,249	
Other	220,163	
Property and Equipment, net	5,885,289	
Notes receivable, less current portion	263,650	
Goodwill, net	1,046,944	
Intangible assets, net	110,025	
Other	88,050	
Accounts payable		$ 877,832
Accrued salaries and wages		-
Other accrued expenses		946,528
Dividends payable		602,694
Deferred income		220,938
Deferred income taxes		894,429
Common stock		180,808
Additional paid-in capital		7,626,602
Retained earnings		3,343,850
Sales		22,944,017
Franchise and royalty fees		5,492,531
Cost of sales	14,693,786	
Franchise costs	1,499,477	
Sales & marketing	1,505,431	
General and administrative	1,782,947	
Retail operating	1,750,000	
Depreciation and amortization	-	
Interest income		27,210
Income Tax Expense	2,090,468	
	$ 43,157,439	$ 43,157,439

Table 3-4 Rocky Mountain Chocolate Factory's Adjusted Trial Balance

Rocky Mountain Chocolate Factory, Inc.
Adjusted Trial Balance
February 28, 2010

Account title	**Debit**	**Credit**
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	
Property and Equipment, net	5,186,709	
Notes receivable, less current portion	263,650	
Goodwill, net	1,046,944	
Intangible assets, net	110,025	
Other	88,050	
Accounts payable		$ 877,832
Accrued salaries and wages		646,156
Other accrued expenses		946,528
Dividend payable		602,694
Deferred income		220,938
Deferred income taxes		894,429
Common stock		180,808
Additional paid-in capital		7,626,602
Retained earnings		3,343,850
Sales		22,944,017
Franchise and royalty fees		5,492,531
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	
Interest income		27,210
Income Tax Expense	2,090,468	
	$ 43,803,595	$ 43,803,595

Table 3-5 Rocky Mountain Chocolate Factory's Income Statement

Rocky Mountain Chocolate Factory, Inc. Statements of Income			
	For the years ended February 28 or 29		
	2010	2009	2008
Revenues			
Sales	$22,944,017	$22,453,165	$25,558,198
Franchise and royalty fees	5,492,531	6,085,534	6,319,985
Total revenues	28,436,548	$28,538,699	$31,878,183
Costs and Expenses			
Cost of sales, exclusive of depreciation and amortization expense of $336,009, $370,485 and $389,273, respectively	14,910,622	15,077,143	16,678,472
Franchise costs	1,499,477	1,718,595	1,498,709
Sales & marketing	1,505,431	1,495,442	1,503,224
General and administrative	2,422,147	2,562,280	2,505,676
Retail operating	1,756,956	1,107,872	994,789
Depreciation and amortization	698,580	758,322	782,951
Total costs and expenses	22,793,213	22,719,654	23,963,821
Operating income	5,643,335	5,819,045	7,914,362
Other Income (Expenses)			
Interest expense	-	(15,851)	(1,566)
Interest income	27,210	21,341	102,360
Other, net	27,210	5,490	100,794
Income Before Income Taxes	5,670,545	5,824,535	8,015,156
Income Tax Expense	2,090,468	2,105,972	3,053,780
Net Income	$ 3,580,077	$ 3,718,563	$ 4,961,376
Basic Earnings per Common Share	$ 0.60	$ 0.62	$ 0.78
Diluted Earnings per Common Share	$ 0.58	$ 0.60	$ 0.76
Weighted Average Common Shares Outstanding	6,012,717	5,984,791	6,341,286
Dilutive Effect of Employee Stock Options	197,521	172,265	159,386
Weighted Average Common Shares Outstanding, Assuming Dilution	6,210,238	6,157,056	6,500,672

Disclosure: The amount of depreciation excluded from cost of sales and the calculations of weighted average common shares outstanding with and without dilution are additional amounts provided by Rocky Mountain Chocolate Factory's example income statement but are not calculated within the data sheet.

Table 3-6 Rocky Mountain's Statement of Retained Earnings

Rocky Mountain Chocolate Factory, Inc. Statement of Retained Earnings For the Year Ended February 28, 2010	
Retained Earnings, February 28, 2009	$ 5,751,017
Add: Net Income	3,580,077
Less: Dividends	(2,407,167)
Retained Earnings, February 28, 2010	$ 6,923,927

Table 3-7 Rocky Mountain Chocolate Factory's Balance Sheets

Rocky Mountain Chocolate Factory, Inc.
Balance Sheets

	As of February 28	
	2010	2009
Assets		
Current Assets		
Cash and cash equivalents	$ 3,743,092	$ 1,253,947
Accounts receivable, less allowance for doubtful accounts of $395,291 and $332,719, respectively	4,427,526	4,229,733
Notes receivable, current	91,059	-
Inventories, less reserve for slow moving inventory of $263,872 and $251,922, respectively	3,281,447	4,064,611
Deferred income taxes	461,249	369,197
Other	220,163	224,378
Total current assets	12,224,536	10,141,866
Property and Equipment, net	5,186,709	5,253,598
Other assets		
Notes receivable, less current portion	263,650	124,452
Goodwill, net	1,046,944	1,046,944
Intangible assets, net	110,025	183,135
Other	88,050	91,057
Total other assets	1,508,669	1,445,588
Total assets	$ 18,919,914	$ 16,841,052
Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts payable	$ 877,832	$ 1,074,643
Accrued salaries and wages	646,156	423,789
Other accrued expenses	946,528	531,941
Dividend payable	602,694	598,986
Deferred income	220,938	142,000
Total current liabilities	3,294,148	2,771,359
Deferred Income Taxes	894,429	827,700
Stockholders' Equity		
Common stock, $0.03 par value; 100,000 shares authorized; 6,026,938 and 5,989,858 shares issued and outstanding, respectively	180,808	179,696
Additional paid-in capital	7,626,602	7,311,280
Retained earnings	6,923,927	5,751,017
Total stockholders' equity	14,731,337	13,241,993
Total liabilities and stockholders' equity	$ 18,919,914	$ 16,841,052

Disclosure: The amounts listed for allowance for doubtful accounts, slow-moving inventory, and the following descriptions of preferred stock are necessary disclosures but are provided by Rocky Mountain Chocolate Factory's example balance sheet and are not derived from the data sheet.
Preferred stock, $0.10 par value, 250,000 authorized; Series A Junior Participating Preferred Stock, authorized 50,000 shares; and Undesignated series, authorized 200,000 shares

The previous trial balances and financial statements illustrate the relationships between the different stages of the accounting cycle. Rocky Mountain Chocolate Factory's transactions were recorded in journal entries, and changes in each account were accumulated in the unadjusted trial balance. After the company recorded adjusting entries, an adjusted trial balance was prepared to show the balance of each account at year end. Then, from the adjusted trial balance, Rocky Mountain prepared an income statement, revealing the company's revenues and expenses. The net income line item on the income statement is carried into the calculation of retained earnings on the statement of retained earnings. Furthermore, retained earnings is a component of equity. Thus, the amount of retained earnings is included in the balance sheet. The statement of cash flows is the final financial statement prepared by companies, and it classifies transactions into the categories of operating, investing, and financing activities. While not a full statement of cash flows, Table 3-8 presents the classifications of Rocky Mountain's transactions.

Table 3-8 Cash Flow Statement Classifications

Transaction	Classification
1. Purchase inventory	operating
2. Incur factory wages	operating
3. Sell inventory for cash and on account	operating
4. Pay for inventory	operating
5. Collect receivables	operating
6. Incur SG&A (cash and payable)	operating
7. Pay wages	operating
8. Receive franchise fee	operating
9. Purchase PPE	investing
10. Cash dividends declared and paid	financing
11. All other transactions	operating, investing, and/or financing
12. Adjust for inventory count	operating
13. Record depreciation	operating
14. Wage accrual	operating
15. Consultant's report	no transaction

Conclusion

Rocky Mountain Chocolate Factory's datasheet, journal entries, trial balances, and financial statements highlight the connections between each step of the accounting cycle and between the different financial statements. As the final step in the financial reporting process, Rocky Mountain prepares closing entries to close out all temporary accounts, like revenues and expenses. Table 3-9 presents a trial balance that reflects the effects of closing entries. With closing entries complete, Rocky Mountain Chocolate Factory is prepared to begin the financial reporting process anew in the next year.

Table 3-9 Rocky Mountain Chocolate Factory's Post-closing Trial Balance

Rocky Mountain Chocolate Factory, Inc. Post-closing Trial Balance February 28, 2010		
Account title	**Debit**	**Credit**
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	
Property and Equipment, net	5,186,709	
Notes receivable, less current portion	263,650	
Goodwill, net	1,046,944	
Intangible assets, net	110,025	
Other	88,050	
Accounts payable		$ 877,832
Accrued salaries and wages		646,156
Other accrued expenses		946,528
Dividends payable		602,694
Deferred income		220,938
Deferred income taxes		894,429
Common stock		180,808
Additional paid-in capital		7,626,602
Retained earnings		6,923,927
	$ 18,919,914	$ 18,919,914

Case 4

Examining Fraud Schemes and Internal Controls

October 19, 2016

Summary

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

Table 4-1 Analyzing Fraud Schemes and Internal Control Procedures

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

Table 4-1 (continued)

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

Case 5

Inventory Accounts

November 2, 2016

Executive Summary

As a manufacturing company produces goods, it records raw materials inventory, work-in-process inventory, and finished goods inventory on its balance sheet. Utilizing these balance sheet accounts, the manufacturing company can analyze the flow of costs during the production process.

Inventory Analysis

1. The raw materials inventory account includes the costs of acquiring unaltered goods that will be used in production. These costs include the amounts paid for the actual goods as well as the costs for freight-in. Raw materials inventory may include the costs for materials like metal, wood, screws, or other items that have not yet been used in production. Raw materials will include direct materials that can be traced to a specific unit of product as well as indirect materials that are not easily traced to a single unit of production. In addition, the work-in-process inventory account consists of the costs for products in process but not yet completed. Thus, the work-in-process account will contain costs of raw materials used in production as well as the direct labor and overhead used so far during production. Finally, the finished goods inventory account consists of the costs of units completed but not yet sold. For instance, a car manufacturer's finished goods inventory would include all the costs for direct material, direct labor, and overhead used in a completed car ready for sale.

2. The inventory balance is recorded net of an estimated allowance established for obsolete and unmarketable inventory. According to Note 2, this estimated allowance

was determined from current inventory levels, sales trends, historical experience, estimates of market conditions, and forecasts of future product demand.

3a. The account for the allowance for obsolete or unmarketable inventory does not appear directly on the company's financial statements. Instead, it is treated as a contra account against the balance sheet's inventory account. The creation of this inventory reserve also leads to an increase in the cost of goods sold reported on the income statement, and a write-off or disposal will lead to a decrease in the reserve and in the inventory account.

3b. The gross amount of inventory at the end of 2011 is $243,870 (in thousands). The gross amount of inventory at the end of 2012 is $224,254 (in thousands). These gross amounts are calculated by adding the reported inventory amount from the balance sheet to the balance of the allowance for obsolete or unmarketable inventory account.

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

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

3c. The nature of an obsolete good is non-saleable or non-useable. Thus, the majority of the reserve is likely applied to finished goods. The company may not be able to sell the completed goods as they are no longer desired by customers. The items may have a short-shelf life or may experience rapid obsolescence. The company could have also over-produced and failed to sell the remaining finished goods. In addition, a smaller portion of the reserve may be attributable to raw materials inventory. Raw

materials may have been over-purchased, outdated, or perishable. Thus, they are never used in production. Finally, work-in-process inventory contributes the smallest percentage, if any, toward the reserve for obsolescence. In fact, the work-in-process inventory account is only 0.29 percent of total inventory for 2012, so the amount of obsolete inventory from work-in-process likely reflects this small percentage.

4. The entries (in thousands) to record the activity in the reserve follow.

	Debit	Credit
Cost of Goods Sold	$13,348	
Allowance for Obsolete Inventory		$13,348
To record a provision for obsolete or unmarketable inventory		

	Debit	Credit
Allowance for Obsolete Inventory	$11,628	
Inventory		$11,628
To record a write down of inventory		

5. The T-accounts for raw materials inventory, work-in-process inventory, finished goods inventory, cost of sales, and accounts payable follow in Table 5-1.

Table 5-1 Analyzing Inventory Activity in T-accounts (in thousands)

Raw Materials Inventory (Debit)	Raw Materials Inventory (Credit)	Work-in-Process Inventory (Debit)	Work-in-Process Inventory (Credit)	Finished Goods Inventory (Debit)	Finished Goods Inventory (Credit)
$46,976		$1,286		$184,808	
438,561		126,000			13,348
	442,068		568,735		572,549
		442,068		568,735	
$43,469		$619		$167,646	

Cost of Sales (Debit)	Cost of Sales (Credit)	Accounts Payable (Debit)	Accounts Payable (Credit)
-			$39,012
$13,348			438,561
		432,197	
572,549			
$585,897			$45,376

These T-accounts can be analyzed to reveal the flow of inventory costs (in thousands).

5a. The cost of finished goods sold in the current year is $572,549.

5b. The cost of finished goods transferred from work-in-process is $568,735 for the current year.

5c. The cost of raw materials that was transferred to work-in-process is $442,068.

5d. The cost of raw materials purchased in the current year is $438,561.

5e. The amount of cash used to pay for raw material purchases is $432,197.

6. Inventory turnover is the calculation of cost of sales divided by the average of inventories. The company's inventory turnover ratio for the current year is 2.63 times, and the inventory turnover for the previous year was 2.29 times.

   2012 Inventory turnover ratio = $585,897/(($211,734 + $233,070)/2) = 2.6344 times

   2011 Inventory turnover ratio = $575,226/(($233,070 + $268,591)/2) = 2.2933 times

7. The inventory holding period is how many days the company needed to manufacture and sell its inventory. The inventory holding period for the current year is approximately 139 days. In contrast, the company required 159 days to manufacture and sells its inventory in 2011. Thus, the company is becoming more efficient in its inventory management. Though still requiring a significant inventory period of over 100 days, the company was able to move its inventory more quickly in 2012.

   2012 Inventory holding period = 365/2.6344 times = 138.55 days

   2011 Inventory holding period = 365/2.2933 times = 159.16 days

8. As one can calculate the percentage of accounts receivable that are uncollectible, the manufacturing company can follow a similar method to calculate the percentage of finished goods that are obsolete. The particular year's ending balance of the obsolete inventory reserve is divided by the gross amount of finished goods inventory. Thus, the percentage of finished goods that were estimated as obsolete in 2012 is 6.9 percent. In addition, 5.5 percent of finished goods were estimated to be obsolete in 2011.

   2012: $12,520 / ($167,646 + $12,520) = 0.06949 = 6.9%

   2011: $10,800 / ($184,808 + $10,800) = 0.05521 = 5.5%

   Furthermore, the company could calculate the 2012 provision as a percentage of finished goods inventory.

   2012 provision: $13,348 / ($167,646 + 13,348) = 7.4%

   Nevertheless, an investor or analyst would want to know why inventory is considered unmarketable and why the percentage of finished goods inventory that is obsolete increased from 2011 to 2012. An analyst might also wish to know if the company can increase sales and simultaneously reduce the amount of obsolete or unmarketable inventory. For instance, the investor might ask if the manufacturing company could become more profitable if it implemented a just-in-time inventory strategy that allowed the company to reduce inventory storage time and related costs.

Conclusion

The manufacturing company possesses raw materials inventory, work-in-process inventory, and finished goods inventory. In addition, the company utilizes an allowance for inventory that may be obsolete or unmarketable. Through these specialized inventory accounts, the company can calculate ratios for inventory turnover and inventory holding period that reveal increased efficiency as well as opportunities for improvement.

Case 6

Capitalized Costs and Earnings Quality

November 16, 2016

Executive Summary

The telecommunications company WorldCom, Inc. became embroiled in a financial scandal in 2002 due to its accounting choices. The company categorized a significant portion of costs as capital expenditures rather than as operating expenses, and this one accounting decision, which represented millions of dollars, turned a loss into a profit on the company's income statement.

Analysis of Financial Reporting of Line Costs

A. i. The FASB Statement of Concepts No. 6 defines assets as economically beneficial resources owned or controlled by an entity that are expected to have future economic value. In addition, an expense is an outflow, utilization of assets, and/or incurrence of liabilities caused by an entity's central revenue-producing operations, such as creating goods or providing services.

ii. Costs should be expensed when they are used in the period or when they have no measurable future economic value. Meanwhile, costs should be capitalized as assets when they have future economic value and will be matched with future revenues.

B. After their initial capitalization, costs are gradually matched with revenues over multiple periods. Thus, the decision to capitalize costs affects both the balance sheet and income statement. During the initial capitalization, the incurrence of costs affects only the balance sheet as the costs are capitalized as assets and paid for with a balance sheet account. After the initial capitalization, the costs are gradually expensed to the

income statement, likely to depreciation or amortization expense, over the determined life of the asset. The costs are also then credited to an account, such as accumulated depreciation, that will decrease the value of assets on the balance sheet. Consequently, the decision to capitalize a specific cost initially prevents the income statement from experiencing a significant reduction in profit and instead spreads the cost across multiple periods.

C. WorldCom, Inc. reported line costs of $14,739 (in millions) for the year ended December 31, 2001. The entry to record these costs as an expense follows.

	Debit	Credit
Line Costs (Expense)	$14,739,000,000	
Cash		$14,739,000,000
To record line cost expense.		

These line costs are costs paid to local telephone networks to use their lines to complete calls. While WorldCom, Inc. did not fully specify what these costs included, a filing with the Securities and Exchange Commission showed that line costs primarily consisted of access charges and transport charges.

D. Line costs associated with ongoing activities were improperly capitalized at WorldCom. Transactions for leasing lines to support WorldCom's central operations created these line costs. Thus, these costs did not meet the definition of an asset. They were ordinary expenses and did not create a long lasting asset that would produce a future economic benefit.

E. WorldCom reversed the categorization of the line cost expense in order to capitalize the expense in property, plant, and equipment accounts. The entry that removed line costs from expenses follows.

Property, Plant, and Equipment	$3,055,000,000	
Line Costs (Expense)		$3,055,000,000
To capitalize line costs.		

These costs appear in the asset section of the balance sheet under property, plant, and equipment. Specifically, WorldCom allocated these capitalized costs among transmission equipment, communications equipment, and such accounts. On the statement of cash flows, the capitalized costs would appear in the investing section as capital expenditures rather than in the operating section.

F. After capitalizing the line costs as assets on the balance sheet, WorldCom, Inc. calculated and recorded a total depreciation expense of $83,306,818.19 in 2001 as calculated in Table 6-1.

Table 6-1 Calculating Depreciation Expense of Capitalized Assets

2001 Depreciation expense	
Quarter 1: ($771 million / 22 years) * (4/4 quarters) =	$35,045,454.55
Quarter 2: ($610 million / 22 years) * (3/4 quarters) =	$20,795,454.55
Quarter 3: ($743 million / 22 years) * (2/4 quarters) =	$16,886,363.64
Quarter 4: ($931 million / 22 years) * (1/4 quarters) =	$10,579,545.45
Total	$83,306,818.19

The entry to record the depreciation expense for 2001 follows.

Depreciation Expense	$83,306,818.19	
Accumulated Depreciation – Equipment		$83,306,818.19
To depreciate capitalized assets.		

G. If WorldCom had not improperly capitalized line costs, the 2001 income statement would have shown a net loss of $341,150,568 as calculated in Table 6-2 with the assumption that an income tax benefit is realized.

Table 6-2 Net Income without Improperly Capitalized Line Costs

WorldCom, Inc. Partial Income Statement, Restated For Year Ended December 31, 2001	
Income before taxes, as reported	$ 2,393,000,000
Add: Depreciation	83,306,818
Deduct: Line costs that were improperly capitalized	(3,055,000,000)
Loss before taxes, restated	(578,693,182)
Income tax benefit (Loss * tax rate)	202,542,614
Add: Minority interest	35,000,000
Net loss, restated	$ (341,150,568)

This net loss is materially different from the positive profit reported in WorldCom's 2001 income statement. The decision to capitalize line costs dramatically affected the perception of WorldCom, Inc. as a profitable company in 2001.

Conclusion

WorldCom, Inc. engaged in fraudulent accounting when the company capitalized costs that should have been considered operating expenses. This accounting choice allowed the company to defer costs so that the current year's income was not reduced by the total amount of the costs. Thus, WorldCom, Inc. was able to present a billion-dollar profit in 2001 when the company's income statement would have reflected a loss if proper accounting had been followed.

Case 7

Restructuring Costs

February 8, 2017

Executive Summary

Targa Co. is restructuring one of its business lines and has developed a restructuring plan. In accordance with this plan, Targa will terminate certain employees and will provide them with termination benefits. In addition, the restructuring plan includes a relocation to a new facility in a different geographic location, and Targa will incur relocation costs and staff training costs. As it prepares financial statements for the year ended December 31, 20X1, Targa must determine how to account for these new costs in accordance with the generally accepted accounting principles of the United States (U.S. GAAP).

Employee Benefits

During the restructuring process, Targa plans to provide benefit payments to employees who are terminated. The restructuring plan includes three different types of benefit payments: a one-time, nonvoluntary termination benefit contingent on employees' service through the date of the facility's close, a traditional two weeks' severance, and an additional lump-sum benefit for the facility manager.

The Financial Accounting Standards Board (FASB) provides much of its guidance for costs related to exit and disposal activities, including restructuring, in the ASC 420 section of the FASB Codification. Targa can look to this section to first determine the proper accounting treatment for the $2.5 million estimated termination benefit. Listing examples of costs that are associated with exit or disposal activities, ASC 420-10-05-2 describes "involuntary employee termination benefits pursuant to a one-time benefit arrangement that, in substance, is not an ongoing benefit arrangement or an individual deferred compensation contract." Because the estimated benefit of $2.5

million applies only to one current restructuring activity, it will be treated as a one-time employee termination benefit under ASC 420. According to ASC 420-10-25-4, an arrangement for a one-time employee termination benefit exists when it is communicated to employees and meets the following criteria:

> 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 (ASC 420-10-25-4).

As the inter-office memorandum reveals, management has satisfied the first criterion by committing to restructuring and communicating the termination plan. In addition, management identifies the affected employees as 120 to 125 engineering, facility management, and operational management employees at Plant A facility in Brooklyn Park, Minnesota. The memorandum also reveals the expected completion date of the termination process to be January 31, 20X2. Further meeting the criteria, management provides the terms of the 12 weeks of pay benefits, part of which are contingent on service. Finally, the memo suggests that the restructuring plan will not be significantly

changed or withdrawn. Together, Targa's actions meet the criteria provided in ASC 420-10-25-4, and an arrangement for a one-time termination benefit is created. Moreover, ASC 420-10-25-5 states that "an entity's communication of a promise to provide one-time employee termination benefits is a promise that creates an obligation at the communication date to provide the termination benefits if employees are terminated." Thus, Targa should recognize the one-time employee termination benefit on the 20X1 financial statements since the inter-office memorandum is communicated on December 27, 20X1.

Furthermore, the FASB provides explanations for the recognition and the measurement of the liability created by the benefit. "If employees are required to render service until they are terminated in order to receive the termination benefits and will be retained to render service beyond the minimum retention period, a liability for the termination benefits shall be measured initially at the communication date based on the fair value of the liability as of the termination date" (ASC 420-10-30-6). If the benefit meets the conditions of required service beyond the retention period, ASC 420-10-30-6 adds that the liability should also be recognized ratably over the future service period. Thus, because the benefit is dependent on employees' continued service through the close of the facility, Targa's liability for the termination benefits will be based on the fair value of $2.5 million, and if the liability is recognized ratably, a portion of the $2.5 million will be recognized on the 20X1 financial statements.

After determining the treatment of the $2.5 million benefit as a one-time termination benefit, Targa must now determine how to classify the two weeks' severance package. Since Targa has a historical practice of providing two weeks' severance to

individual employees upon nonvoluntary termination, the $500,000 cost of the severance is considered an ongoing benefit arrangement. ASC 420-10-55-1 provides for this treatment as it states, “Absent evidence to the contrary, an ongoing benefit arrangement is presumed to exist if an entity has a past practice of providing similar termination benefits.” ASC 712 provides guidance for the accounting of an ongoing benefit arrangement. In fact, ASC 712-10-05-5 specifically lists severance benefits as an example of other postemployment benefits. Thus, Targa will account for the estimated severance pay as directed by ASC 712-10-25-4 and ASC 712-10-25-5. As these sections require, a liability should be recognized when a future settlement is probable and when the benefits are reasonably estimable. Thus, Targa will record the liability and expense for the two weeks’ severance in the 20X1 financial statements since the cost can be estimated at $500,000 and the payment of the severance became probable in 20X1 with the announcement of the restructuring plan.

Finally, with regards to employee benefits, Targa must determine how to account for an additional lump-sum benefit to be paid to the facility manager. The existence of the provision for the lump-sum benefit in the manager’s employment agreement suggests that this termination benefit is part of an ongoing benefit arrangement. Benefits paid to employees in connection with a termination can be in the form of “contractual termination benefits required by the terms of a plan only if a specified event, such as a plant closing, causes employees’ services to be terminated involuntarily” (ASC 712-10-05-2). In addition, ASC 712-10-25-2 explains that “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.”

Thus, Targa will recognize the termination benefit at its estimated/fair value amount of $50,000 on the 20X1 financial statements as an expense and a liability.

Retraining and Relocation Costs

As part of its restructuring, Targa will also incur a relocation cost of $500,000 and staff training cost of $1.5 million. FASB considers other costs associated with an exit or disposal activity to include "costs to consolidate or close facilities and relocate employees" (ASC 420-10-25-14). Considering the relocation and retraining costs to fall under this "other associated costs" category, one will not account for these costs in the 20X1 financial statements. The FASB explains that "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" (ASC 420-10-25-15). Since Targa has not actually incurred the retraining or relocation expenses, these estimated costs will not be recognized on the 20X1 financial statements. Instead, ASC 420-10-25 states that such costs "shall be recognized in the period in which the liability is incurred (generally, when goods or services associated with the activity are received)."

Conclusion

To follow U.S. GAAP in its accounting choices, Targa Co. can utilize the FASB Codification to determine appropriate treatments for costs related to a new restructuring plan. The guidance provided in the Codification helps Targa to distinguish between one-time benefit arrangements and ongoing benefit arrangements. In addition, the detailed rules suggest the differences between costs that should be recognized in 20X1 because

they are estimable and probable and costs that should not be recognized in the financial statements until they are incurred. Through the guidance provided by FASB standards, Targa's accountants can prepare 20X1 financial statements that reflect the current restructuring plan.

Case 8

Shareholders' Equity

February 15, 2017

Executive Summary

Merck & Co., Inc. is a global pharmaceutical company headquartered in New Jersey. The company's financial statements present shareholders' equity disclosures, through which individuals can gain insight into the company's issuance of stock, repurchasing of stock, and payment of dividends.

Concepts, Process, and Analysis

A. One can first analyze Merck's common shares.

i. Merck is authorized to issue 5.4 billion shares of common stock.

ii. Merck has issued 2.983 billion common shares at December 31, 2007.

iii. The reconciliation of the number of shares to the dollar value of the common stock can be presented as 2,983,508,675 shares x $0.01 per share = $29,835,086.75. The shares issued at a par value of one cent per share equal the $29.8 billion amount presented under common stock on the December 31, 2007 balance sheet.

iv. Merck has 811 million shares of treasury stock at December 31, 2007.

v. There are 2.172 billion shares outstanding at December 31, 2007. For Merck, the number of shares outstanding can simply be found by subtracting the number of shares of treasury stock from the number of shares issued.

vi. On December 31, 2007, the total market capitalization of Merck is over $125 billion. The total market capitalization can be calculated by multiplying the closing price of $57.61 and the number of shares outstanding at December 31, 2007.

C. Companies pay dividends on their common or ordinary stock to provide shareholders with a return on their investment. This payment may be a positive signal because the company is profitable and has extra cash to spare. Alternatively, a dividend payment can be a negative indication of a lack of growth opportunities as the company is paying dividends rather than re-investing its cash. A company's share price typically decreases upon payment of a dividend because future earnings are being transferred to investors rather than being added to the value of the company.

D. Companies may repurchase their stock for several reasons. To begin, a company may perceive that its stock is undervalued, meaning the stock's current price is less than what the company believes the stock is worth. Companies may also buy back their own shares to provide shareholders with distributions of excess cash. Furthermore, by reducing stockholders' equity and the number of shares outstanding, companies can temporarily increase earnings per share and return on equity ratios through a stock repurchase.

E. Merck's common dividend activity can be summarized in a single journal entry (in millions).

Retained Earnings	3,310.7	
Dividends Payable		3.4
Cash		3,307.3

G. Merck's financial statements also reveal the company's repurchase of stock.

i. Merck utilizes the cost method to account for its treasury stock transactions. According to the cost method, treasury stock is debited at reacquisition cost (the repurchase price)

when it is purchased. All entries to the treasury stock account are made at the original repurchase cost.

ii. According to Note 11 provided with the financial statements, Merck repurchased 26.5 million shares on the open market during 2007.

iii. Merck paid $1,429.7 million in total and $53.95 per share, on average, to buy back its stock during 2007. This purchase of treasury stock represents a financing cash flow.

iv. Merck does not disclose its treasury stock as an asset because the treasury stock will not provide an economic benefit in the future even though it may provide a cash benefit.

I. Individuals can also use ratio analysis to compare Merck's activities in 2006 and 2007. Dividends paid, rather than dividends declared, are used for the ratios in Table 8-1.

Table 8-1 Calculating Dividend Ratios for Merck

(in millions)	2007	2006
Dividends paid	$3,307.3	$3,322.6
Shares outstanding	2,172.5	2,167.8
Net income	$3,275.4	$4,433.8
Total assets	$48,350.7	$44,569.8
Operating cash flows	$6,999.2	$6,765.2
Year-end stock price	$57.61	$41.94
Dividends per share	$1.52	$1.53
Dividend yield	2.64%	3.64%
Dividend payout	100.97%	74.94%
Dividends to total assets	6.84%	7.45%
Dividends to operating cash flows	47.25%	49.11%

Comparing Merck's dividend ratios for 2006 and 2007, one can see that dividend yield, dividends to total assets, and dividends to operating cash flows are all lower for 2007 than for 2006. However, Merck's dividend payout in 2007 increases from 2006. Even though Merck's net income decreases by over $1 billion between 2006 and 2007, the company chose to increase the percentage of net income paid out in dividends. In fact, Merck pays out over 100 percent of its net income in 2007 through dividends. This is a surprisingly large dividend payout and is likely difficult to maintain.

Conclusion

The financial statements of Merck & Co., Inc. present shareholders' equity for the year ended December 31, 2007. Through analysis of these statements, individuals can begin to understand the impact of stock issuances, purchases of treasury stock, and payment of dividends.

Case 9

Stock-Based Compensation

March 1, 2017

Executive Summary

Stock-based compensation is a method corporations use to compensate their employees with stock rather than cash payments. Xilinx, Inc. is such a company that offers equity incentive plans. An analysis of its 2013 financial statements reveals Xilinx's accounting for stock compensation and also highlights the tax effects of compensating employees with stock.

Concepts, Process, and Analysis

A. Xilinx's employee stock option plan offers an employee the option to buy a particular number of shares of common stock at a given price over an extended period of time. After a certain period of time called the vesting period, the employee may exercise his stock option and buy the shares of stock at the predetermined price. If the fair market value of the stock increases, such stock option plans provide employees with the incentive of being able to purchase stock at a lower price than its future fair market value. Thus, stock option plans provide employees with a type of compensation and also encourage employees to reach high levels of performance that will raise the company's stock price.

B. Restricted stock units (RSUs) are grants valued in terms of company stock, but company stock is not actually issued at the time of the grant. RSUs are grants of units, and each unit will equal a share of stock when it vests. Once the vesting requirement is met, the company will distribute shares or the cash equivalent used to value the shares. In contrast, a stock option provides an offer to buy a certain number of shares at a

particular price. A company like Xilinx may choose to offer both programs to employees because the different plans offer different levels of risk and produce different tax benefits. For instance, restricted stock will always have value while stock options can become worthless if the stock price does not exceed the option's exercise price. Employers may also offer both programs because they offer different tax benefits for employees who have different desires. Stock options are typically not taxed as income until the time of their exercise while RSUs are generally taxed when they vest.

C. Notes 2 and 6 present additional terms associated with stock-based compensation.

- Grant date – The grant date is the date of the initiation of the stock plan or contract. For stock option plans, employees do not actually receive the stock on the grant date, but rather they are granted the option.
- Exercise price – This is the specified price at which the owner of an option can buy the stock.
- Vesting period – The vesting period is the time between the grant date and the vesting date. It is the amount of time an employee must wait before he or she can exercise an option. Typically, the vesting period is the amount of time that employees must perform service before they can exercise the option.
- Expiration date – This is the date at which employees can no longer exercise their stock options.
- Options/RSUs granted – Options or restricted stock units granted are those that have been offered to employees.

- Options exercised – Options are exercised when an employee uses his right specified at the grant date to buy shares of the company's stock.
- Options/RSUs forfeited or cancelled – Options or RSUs are forfeited or cancelled when an individual fails to exercise the option before the expiration date or gives up his or her right to the RSU/option.

D. With Xilinx's employee stock purchase plan, qualified employees are permitted to purchase stock at a discounted price over a 24 month purchase period at the end of each 6 month exercise period. An incentive of an employee stock purchase plan is that it allows employees to obtain ownership in the company by purchasing stock at the discounted price often through a salary reduction. The widespread coverage of an employee stock purchase plan is another benefit as approximately 78% of all eligible Xilinx employees participate in the plan. The incentives of an employee stock purchase plan differ from those under employee stock options and RSU plans as there is no risk related to the stock price versus the exercise price. Also, there may be no tax consequences to the employee until the employee decides to sell the stock.

E. Xilinx offers stock options, RSUs, and employee stock purchase plans for which Xilinx must determine the proper accounting. According to authoritative guidance for accounting for share-based payments, Xilinx must measure the cost of all equity awards that it expects will be exercised using the fair value of the awards at the grant date. Then, the company must record these costs as compensation expense over the period for which employees must perform service to receive the award. Xilinx utilizes the straight-line

method to recognize compensation costs over the required service period. Xilinx accounts for employee stock option activity by recording no entry at the date of grant. Then, Xilinx records a debit to an expense and a credit to Paid in Capital – Stock Options in the periods in which its employees perform the service. If employees exercise their options, Xilinx will record debits to Cash and Paid-in Capital – Stock Options and credits to Common Stock and Paid-in Capital in Excess of Par. To account for restricted stock activity, Xilinx also determines the fair value of the restricted stock at the date of grant and expenses that amount over the service period. Finally, Xilinx's employee stock purchase plan is deemed to be compensatory by authoritative guidance. Thus, the employee stock purchase plan is included in Xilinx's calculations of compensation expense.

F. Xilinx's income statement, statement of cash flows, and additional disclosures provide insight into compensation expense.

i. The total expense for stock-based compensation in 2013 is $77,862 thousand.

ii. The statement of income reflects this expense in three different expense accounts. The expense is included under cost of revenues; research and development expense; and selling, general, and administrative expense. The use of different expense accounts suggests that different types of employees benefit from the stock compensation. For example, compensation expense related to factory workers can be included in cost of revenues. Likewise, benefits for scientists may be reflected in R&D expense, and the costs of benefits for salespeople or executives would be recorded in selling, general, and administrative expense.

iii. The total expense for stock-based compensation does not involve cash flows even though it does reduce net income. Thus, the expenses are added back in the operating section of the statement of cash flows to reconcile net income to net cash provided by operating activities. The excess tax benefit from stock-based compensation is reflected in the financing section of the statement of cash flows.

iv. Financial accounting allows the deduction of compensation expense in the current year. However, tax law does not allow the full compensation expense to be deducted in the current year. Instead, the deduction will be deferred to the future, and this deferral thus creates a deferred tax asset. Excess tax benefits are realized benefits from tax deductions for exercised options in excess of the deferred tax asset for such options.

v. The journal entry to record Xilinx's 2013 stock-based compensation expense follows (in thousands):

Account	Debit	Credit
Cost of Revenues	6,356	
Research and Development Expense	37,937	
Selling, General, and Administrative Expense	33,569	
Additional Paid in Capital – Stock Options		77,862
Deferred Tax Asset	22,137	
Income Tax Payable		22,137

I. The article "Last Gasp for Stock Options" examines recent trends in stock-based compensation.

i. The *Wall Street Journal* article "Last Gasp for Stock Options" discusses the trend of a decreased use of stock options and an increased use of restricted stock awards. In recent years, companies have found restricted stock plans to be more attractive. Companies are

beginning to favor RSUs because restricted stock plans offer employees less risk, are simpler, and result in less dilution. Restricted stock is currently subject to fewer accounting rules and tax complexities than stock options. Companies have also begun to weigh the benefits of restricted stock against options because an accounting rule in 2006 began to require companies to record options as expenses. Finally, because restricted stock is initially worth more than options, companies can give out fewer restricted shares and thus minimize dilution. Employees, specifically general employees, seem to also prefer restricted stock awards over stock options because RSUs offer less risk. As seen in the recent financial crisis, stock options have the potential to be worthless if the stock price does not reach the exercise price, but RSUs do not contain such risk. Executives, who have greater control of a company's strategy, may be more willing to take on the risk of stock options.

ii. The trends in grants of options and RSUs by Xilinx are consistent with the trends reported in "Last Gasp for Stock Options." In Note 6 (page 62) of Xilinx's annual report, the summary of option plans activity reveals that Xilinx granted 2,345 thousand shares as of April 3, 2010; 207 thousand shares as of April 2, 2011; and 92 thousand shares as of March 31, 2012. Thus, Xilinx followed the trend of decreased use of stock options. In contrast, the summary of RSU activity shows that Xilinx granted 2,043 shares as of April 3, 2010; 2,977 shares as of April 2, 2011; and 3,018 thousand shares as of March 31, 2012. Thus, Xilinx's use of RSUs increased over the period as the trend in "Last Gasp for Stock Options" suggests.

Conclusion

Stock-based compensation utilizes equity to compensate and reward employees. Through an analysis of Xilinx, Inc.'s financial statements, individuals can understand the use of stock options, restricted stock units, and employee stock purchase plans. Each type of stock compensation offers unique incentives to both employees and the employer.

Case 10

Revenue Recognition

March 8, 2017

Executive Summary

The Financial Accounting Standards Board established a new revenue recognition model that includes five basic steps. These steps consist of identifying the contract(s) with the customer, identifying the performance obligations in the contract, determining the transaction price, allocating the transaction price to the performance obligations, and recognizing revenue when (or as) the performance obligation is satisfied (ASC 606-10-05-04). Through the guidance of these steps, businesses, such as Bier Haus, can determine the correct accounting of revenue for their daily transactions.

Part I

A college student orders and pays for a large plastic cup of beer at Bier Haus, and the bartender prepares the drink and hands it to the student.

Step 1 Identify the contract(s) with a customer: ASC 606-10-25-1 explains that a contract is formed when parties agree and commit to the contract, when payment terms are identified, when the contract has commercial substance, and when it is probable substantially all consideration will be collected. Thus, the contract is to provide beer in exchange for the customer's payment, and the contract is made when the customer agrees to the price.

Step 2 Identify the performance obligations in the contract: The performance obligation is to provide the cup of beer in exchange for the payment from the customer.

Step 3 Determine the transaction price: The transaction price is the $5 that the customer and bartender agreed must be paid in order to receive the cup of beer.

Step 4 Allocate the transaction price to the performance obligations in the contract: The customer pays $5, and Bier Haus provides $5 worth of beer. Thus, $5 is allocated fully to the performance obligation of providing a cup of beer in exchange for the payment.

Step 5 Recognize revenue when (or as) the entity satisfies a performance obligation: Bier Haus satisfies its performance obligation immediately when the transaction occurs. ASC 606-10-25-30 explains that one can consider the following indicators to determine when a performance obligation is satisfied: the entity's right to payment, the customer's legal title to the asset, the transfer of physical possession of the asset to the customer, the customer's responsibility for the risks and rewards of ownership, and the customer's acceptance of the asset. Thus, Bier Haus satisfies its performance obligation at the point in time when the bartender has been paid and hands the drink to the student. Bier Haus may record revenue from the sale of the cup of beer.

Journal Entry:	Cash		5	
		Beer Revenue		5

Part II

The college student makes a combined purchase from Bier Haus by paying $7 for both beer and a mug that can be used for daily refills.

Step 1 Identify the contract(s) with a customer: The contract for this transaction is the agreement between the student and Bier Haus that the student will receive beer and a mug for refills in exchange for $7.

Step 2 Identify the performance obligations in the contract: The performance obligations in the contract are to provide the college student with beer and to provide the student with a mug that can be used for refills in the future. The beer and the mug, while

complementary items, are distinct in that a customer can benefit from each on its own or with other readily available resources (ASC 606-10-25-19). Thus, they each involve a performance obligation to which the transaction price must be allocated.

Step 3 Determine the transaction price: The transaction price is the $7 that the student and bartender agree must be paid to receive both the beer and the mug. This is the consideration that Bier Haus will receive in the transaction.

Step 4 Allocate the transaction price to the performance obligations in the contract: ASC 606-10-32-31 and 32 prescribe how one should allocate a transaction price to a performance obligation on a relative standalone selling price basis. The customer pays $7 to receive beer and a mug with stand-alone selling prices of $5 and $3, respectively. Thus, the $7 transaction price must be allocated to beer revenue and mug revenue. Bier Haus can allocate $4.38 ($7 x 5/8) to beer revenue and $2.62 ($7 x 3/8) to mug revenue.

Step 5 Recognize revenue when (or as) the entity satisfies a performance obligation: Because the bartender provides both the beer and the mug to the customer, Bier Haus has satisfied its performance obligations, and it can record revenue immediately.

Journal Entry:	Cash		7.00	
		Beer Revenue		4.38
		Mug Revenue		2.62

Part III

The college student pays $7 to receive a large beer and a coupon for pretzels because Bier Haus is currently out of pretzels.

Step 1 Identify the contract(s) with a customer: Bier Haus has established a contract with the college student. After the bartender states that the business is out of pretzels, the customer and Bier Haus form a contract for the student to receive a large beer and a

coupon in exchange for $7. Even though the student receives only a coupon and not a pretzel, a contract, which is an agreement between parties that creates enforceable rights and obligations, does exist (ASC 606-10-25-2). Bier Haus has received consideration in exchange for promised goods, so the business is obligated to provide the pretzels if the coupon is later redeemed. The policy of Bier Haus states that coupons can be redeemed any date after the purchase date, and in accordance, ASC 606-10-25-3 allows a contract to have no fixed duration.

Step 2 Identify the performance obligations in the contract: Bier Haus has a performance obligation to provide the customer with a mug of beer currently. Also, the company has an obligation to provide two pretzels if the coupon is redeemed in the future.

Step 3 Determine the transaction price: The transaction price is $7. This is the total consideration given by the customer to the bartender for the transaction.

Step 4 Allocate the transaction price to the performance obligations in the contract: The customer receives beer with a standalone selling price of $5 and a coupon with a standalone selling price of $3.50. Thus, the transaction price of $7 must be allocated to these two items. Bier Haus can allocate $4.12 ($7 x $5/$8.50) to the beer sale and $2.88 ($7 x $3.50/$8.50) to the coupon sale.

Step 5 Recognize revenue when (or as) the entity satisfies a performance obligation: Bier Haus has satisfied the performance obligation of providing the customer with beer, so it may recognize beer revenue. However, Bier Haus has not yet provided the customer with two pretzels, the value of the coupon. Thus, Bier Haus cannot yet recognize revenue from the sale of the coupon but instead must record unearned/deferred revenue. Since

Bier Haus expects all coupons to be redeemed, it does not have to estimate or account for the possibility of unredeemed coupons.

Journal Entry:	Cash		7.00	
		Beer Revenue		4.12
		Unearned Pretzel Revenue		2.88

Part IV

The college student returns to Bier Haus, orders two pretzels, and pays with the coupon.

Step 1 Identify the contract(s) with a customer: A new contract is not formed in this transaction. Instead, the redemption of the coupon is part of the contract in Part III in which the customer paid for a coupon that could be used as payment to receive two pretzels.

Step 2 Identify the performance obligations in the contract: Bier Haus has the obligation to provide two pretzels when the customer redeems a pretzel coupon.

Step 3 Determine the transaction price: The customer pays for the pretzels by redeeming a coupon rather than paying cash of $4. Additionally, while the coupon is typically sold for $3.50, the allocation to the coupon in the previous transaction was $2.88. Thus, the transaction price for the redemption of the coupon is $2.88 since this is the amount of consideration that Bier Haus is receiving.

Step 4 Allocate the transaction price to the performance obligations in the contract: The transaction price of $2.88 was allocated in the previous transaction in Part III. The full $2.88 is allocated to the performance obligation of providing two pretzels in exchange for the coupon.

Step 5 Recognize revenue when (or as) the entity satisfies a performance obligation:

Because the bartender fulfills the performance obligation by providing the student with two pretzels in exchange for the coupon, Bier Haus can now recognize revenue that was previously deferred.

Journal Entry:	Unearned Pretzel Revenue	2.88	
	Pretzel Revenue		2.88

Conclusion

The five steps of the revenue recognition model are broad guidelines that can be adapted to many types of transactions. Through the model, Bier Haus can determine proper accounting for revenue generated from sales of beer, mugs, and pretzel coupons.

Case 11

Deferred Income Taxes

March 22, 2017

Executive Summary

ZAGG, Inc. must prepare financial statements and pay income taxes. However, the income reported in the company's financial statements does not reflect the income upon which taxes paid to the IRS are computed. Nevertheless, through the financial statements, one can analyze various tax concepts.

Concepts and Process

A. Book income is the pretax income reported in a company's financial statements. In ZAGG's statement of operations, book income is $23,898 thousand, which is the amount of income before taxes. A company's book income differs from its taxable income due to different rules for determining amounts included in each of these income calculations. The differences that arise between book income and tax income are attributable to permanent or temporary differences.

B. i. Permanent tax differences – Permanent tax differences are differences between taxable income and pretax financial income that never reverse. They are the results of items that enter into pretax financial income but never into taxable income, or that enter into taxable income but never into pretax financial income. Permanent tax differences do not give rise to future taxable or deductible amounts. Examples of items that are recognized for financial purposes but not tax purposes include interest received on state and municipal obligations, fines and expenses resulting from a violation of law, and proceeds from or premiums for life insurance carried by the company on key officers or employees. In addition, items recognized for tax

purposes but not for financial purposes include percentage depletion of national resources in excess of their cost and the deduction of dividends received from U.S. corporations.

ii. Temporary tax difference – A temporary tax difference is a difference between pretax financial income and taxable income that results when income or an expense is recognized in a different period for financial accounting purposes than for tax purposes. Temporary tax differences result in taxable amounts or deductible amounts in future years. An example of a taxable temporary difference is the difference that arises from a prepaid expense that is deducted on the tax return before it is expensed in financial income.

iii. Statutory tax rate – This is the tax rate that is actually imposed by law.

iv. Effective tax rate – The effective tax rate is the rate that one actually pays. It is the percentage of total income (taxable and non-taxable income) that is paid in tax.

C. A company reports deferred income taxes as part of total income tax expense to provide a better picture of the company's current tax liability as well as future obligations. Together, income tax expense and deferred income taxes reflect income taxes payable. Companies do not simply report their current tax bill as their income tax expense because the current tax bill is a result of specific tax rules while the income on financial statements should reflect generally accepted accounting principles.

D. Deferred income tax assets represent taxes that will be saved in the future due to deductible temporary differences. For example, using the allowance method for financial reporting purposes, a company can deduct an estimate of bad debt expense in the current year's financial statements while bad debt expense is not deducted for tax purposes until the receivable is written off. Thus, the company has a future tax benefit because it will be able to save taxes in the future when the bad debt is written off.

Deferred income tax liabilities represent increases in taxes payable in future years as a result of taxable temporary differences. For example, a deferred tax liability is created when a company uses straight line depreciation for financial purposes but uses accelerated depreciation for tax purposes. In early years, taxable income will be lower than book income, but in later years, taxable income and thus taxes payable will be higher.

E. A deferred income tax valuation allowance is an account that reduces a deferred tax asset, and it should be recorded when it is more likely than not that at least some portion of the deferred tax asset will not be realized.

F. i. ZAGG prepared the following journal entry (in thousands) to record the income tax provision in fiscal 2012.

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

ii. The net deferred income taxes can be decomposed into $8,002 of deferred tax asset and $291 of deferred tax liability as the following journal entry shows (in thousands).

Account	Debit	Credit
Income Tax Expense	9,393	
Deferred Tax Asset	8,002	
Deferred Tax Liability	291	
Income Tax Payable		17,686

iii. ZAGG's 2012 effective tax rate is 39.3%, as computed by dividing the 2012 income tax expense of $9,393 thousand by the 2012 pre-tax financial income of $23,898 thousand. The effective tax rate varies from the statutory rate of 35% due to permanent tax differences listed in Note 8, such as non-deductible expenses, state tax (net of the federal tax benefit), a domestic production activities deduction, a return to provision adjustment, and an increase in the valuation allowance.

iv. The net deferred income tax asset balance appears as $6,912 thousand under current assets and the remaining $6,596 thousand as deferred income tax assets with the other long-term assets on the balance sheet. A financial statement user would care about this breakdown between current and non-current assets so that he or she would be able to ascertain how much of the deferred tax asset will reverse in the next year versus future years.

Conclusion

An analysis of ZAGG's financial statements and additional notes provides a starting point for discussing various tax concepts. One can even construct a journal entry to reflect ZAGG's income tax provision for 2012.

Case 12

Operating and Capital Leases

April 12, 2017

Executive Summary

Many companies have become involved in leasing assets rather than owning them. Build-A-Bear Workshop, Inc. provides an example of a company who utilizes leases in its business activities. Through an analysis of Build-A-Bear's financial statements and additional disclosures, one can begin to analyze operating leases, capital leases, and their effects on earnings. With an understanding of each type of lease, individuals can identify the advantages of a capital lease versus an operating lease.

Concepts, Process, and Analysis

A. A company may choose to lease an asset rather than purchase it for several reasons. To begin, a lease may require less initial investment as leases often do not require a down payment. In addition, leases offer protection against obsolescence as well as possible tax advantages. Finally, certain leases offer off-balance sheet financing. If a lease is not capitalized, then debt will not be recognized on the balance sheet.

B. An operating lease is a lease under which rent expense accrues as the property is used. For an operating lease, the leased asset does not become part of the lessee's balance sheet, but it remains a capitalized asset on the lessor's balance sheet. A capital lease is a lease in which the lessee treats the leased asset as its own, and lease payments are recorded as payables. The asset under a capital lease is capitalized on the lessee's balance sheet. The FASB provides guidelines for when a rental arrangement should be treated as an operating or capital lease. A direct-financing lease is treated as the financing of an asset purchased by the lessee. Thus, the lessor

records a lease receivable. A sales-type lease is a lease in which there is a manufacturer's or dealer's gross profit (or loss). For a sales-type lease, the lessor records the asset's sales price, cost of goods sold, a reduction to inventory, and a lease receivable.

C. Following guidance provided by the FASB, accountants distinguish between different types of leases in order to report transactions in a manner that best reflects their economic substance. Accountants must determine whether a lease transfers substantially all of the benefits and risks of ownership.

D. i. This lease will be treated as an operating lease under current U.S. GAAP because the lease does not meet the criteria for capitalization. There is not a bargain purchase option at the end of the lease term, and title does not transfer at the lease's end. In addition, the lease term of five years is not greater than 75 percent of the asset's useful life. Finally, the present value of the minimum lease payments is not greater than or equal to 90 percent of the asset's fair value.

ii. Build-A-Bear Workshop records the following journal entry when it makes the first lease payment.

Account	Debit	Credit
Rent Expense	100,000	
Cash		100,000

iii. If Build-A-Bear Workshop is offered "first year rent-free" with its operating lease, then it should recognize the incentive of a rent-free period as deferred rent at

the beginning of the lease. In addition, Build-A-Bear will recognize rent expense evenly across the lease term of five years as shown in Table 12-1.

Table 12-1 Recording Rent Expense and a Rent-free Period

Year 1:	Rent Expense	100,000	
	Deferred Rent		100,000
Year 2:	Rent Expense	100,000	
	Deferred Rent	25,000	
	Cash		125,000
Year 3:	Rent Expense	100,000	
	Deferred Rent	25,000	
	Cash		125,000
Year 4:	Rent Expense	100,000	
	Deferred Rent	25,000	
	Cash		125,000
Year 5:	Rent Expense	100,000	
	Deferred Rent	25,000	
	Cash		125,000

E. i. According to Note 10, rent expense for fiscal 2009 consisted of $45.9 million of base rent expense and $0.9 million of contingent rent. Together, these equal a rent expense of $46.8 million.

ii. The rent expense appears under operating expenses as part of selling, general, and administrative expenses on Build-A-Bear Workshop's income statement for fiscal 2009.

F. i. The present value of the future minimum lease payments is $219,643 thousand as calculated in Table 12-2.

Table 12-2 Calculation of Present Value of Future Minimum Lease Payments

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

ii. If Build-A-Bear Workshop had entered into these leases on January 2, 2010, and if the leases were capital leases, Build-A-Bear Workshop would have recorded the following journal entry (in thousands).

Property and Equipment	219,643	
Lease Obligation		219,643

v. If the leases were capital leases, Build-A-Bear Workshop would have recorded one journal entry to record interest expense and the lease payment and one journal entry to record amortization of the leased asset in fiscal 2010. The journal entries follow (in thousands).

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

G. Under current U.S. GAAP, operating leases offer several incentives to Build-A-Bear's management. One of the most notable benefits of operating leases is the ability to avoid capitalization of the asset and thus avoid adding debt to the company's balance sheet. In addition to increased flexibility and a reduced risk of obsolescence, operating leases are seen by many investors to produce better financial ratios since they do not increase debt or total assets as capital leases do. The use of operating leases is considered by some to decrease the quality of financial statements as such leases result in off-balance sheet accounting that may not fully represent an organization's leasing activities.

H. i. As shown in Table 12-3, one can calculate ratios to compare the differences of recording an operating lease or a capital lease. The ratios under the capital lease column are calculated as of January 2, 2010, which is after the property has been capitalized but before depreciation expense, interest expense, and the reduction of the lease obligation is recorded for fiscal year 2010.

Table 12-3 Comparing Financial Ratios of an Operating and Capital Lease

	Operating Lease	Capital Lease
Current ratio	$\frac{135,755}{81,890} = 1.6578$	$\frac{135,755}{81,890+35,276} = 1.1587$
Long-term debt-to-equity ratio	$\frac{37,603}{164,780} = 0.2282$	$\frac{37,603+184,367}{164,780} = 1.3471$
Long-term debt-to-assets ratio	$\frac{37,603}{284,273} = 0.1323$	$\frac{37,603+184,367}{284,273+219,643} = 0.4405$

The current ratio for a capital lease for Build-A-Bear is lower than the ratio for an operating lease because the current portion of the long-term lease obligation increases

current liabilities and thus decreases the company's current ratio. The debt-to-equity ratio is higher with a capital lease than with an operating lease because the capital lease creates a large increase in long-term debt used in the ratio's calculation. Furthermore, the long-term debt-to-assets ratio is higher with a capital lease because the lease obligation increases long-term debt and the capitalized asset increases total assets. Liquidity and solvency ratios do tend to be weaker for capital leases than for operating leases due to the increased assets and liabilities on the balance sheet. However, due to depreciation, charges to operations tend to be higher in the early years of a capital lease, and thus income as well as retained earnings is lower under the early years of a capital lease. In later years of a lease, income is higher for a capital lease than for an operating lease. Thus, performance ratios for a capital lease are not always weaker than the ratios for an operating lease.

Conclusion

Build-A-Bear Workshop utilized operating leases during fiscal 2009. However, one can also create journal entries as if the company's leases were capital leases. Through a comparison of the two lease treatments, one can analyze the financial effects of each type of lease.