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A JOURNEY OF KNOWLEDGE THROUGH VARIOUS CASE STUDIES

by
Rachel Sidney Rutledge

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

Professor Victoria Dickinson

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This thesis is dedicated to my parents; Linda and Peter Rutledge. Without their love and support,
I would not be where I am today.

ABSTRACT

RACHEL RUTLEDGE: A Journey of Knowledge Through Case Studies
(Under the direction of Dr. Victoria Dickinson)

This thesis projects the profound amount of knowledge in accountancy found within real world scenarios called ‘case studies.’ Each of the twelve chapters in this thesis presents a different topic or problem for Rutledge Consulting Group, in which I, CEO, must use tools like the FASB Codification and financial planning, to help find solutions for our clients. The twelve cases include scenarios dealing with financial analysis for investments, proper allocation of revenues and expenses, internal controls and fraud prevention, inventory, capitalization of costs, employee benefits and retraining, common stock, compensation plans, unearned revenue recognition, deferred income taxes, and differing lease agreements. These twelve case studies went hand-in-hand with the material being taught in Intermediate Accounting I and II. Therefore, the cases can be seen as an extension of knowledge because one would learn the basic material that each accountancy student learns in Intermediate, and then with Dr. Dickinson’s help, would be able to take their learnings from class and turn it into material substance with a real purpose, a solution.

To elaborate more on what is meant by the statement ‘material substance with a real purpose,’ it is important to understand that throughout all the various accounting courses a student takes to receive their Bachelor’s degree, one might not know how any of the vast journal entries and t-accounts they learned about affects day to day aspects of life, until they sit down in a cubicle at one of the big four accounting firms. That is why the knowledge I have learned throughout this course is so priceless, because it has helped me to see what to expect when I graduate and get started in the real world. We study day-in and day-out the rules about balancing, and what to do for this certain expense, but in reality, it is more about taking your learnings,

resources like the codification, and sometimes a little help from your superiors to be able to sit down and work your way through a problem. So, within this study and with help from Dr. Dickinson, I learned how to take basic journal entries and material I was learning in Intermediate and applied them to real life situations.

The process of taking the basic material and applying it to situations that are broader, helped improve my critical thinking process as well. Before, in my two-hundred and three-hundred level accounting classes, I accustomed used to studying and memorizing the material as well as knowing how to work the homework problems inside and out. Yes, this technique is good with any course since it helps lock in and secure the basic material in your mind, but after taking two four-hundred level courses; Advanced Accounting and Income Tax I, I learned that that technique will only get you so far. It is the critical approach and ability to think of different scenarios and situations that a single basic piece of information can apply to, that helped me achieve an outstanding performance within those four-hundred level courses. Not only did my grades show that, but it was also apparent in the happiness that I experienced based on the deeper meaning to everything we learned and how it affects real life. For example, about once every two weeks or so I would run out of Income Tax class and call my mom with such excitement asking her if she was claiming a certain item or if she was doing this differently on her tax return. Sometimes I wonder if this excitement would have been there if I had not taken Dr. Dickinson's course. Regardless, I do thank Dr. Dickinson and this course study that helped show me the critical approach and creativity I had lacked for some time.

Not only did I broaden my horizon throughout this course, but I also learned how to better use the resources that are available to accountants. For example, I had heard about the codification in different classes but had no clue how to use it. After this study, along with my peers, I am happy to say that I am codification proficient and can be able to look up any standard and apply that to problems. My technical skills have also improved with tools like excel

for financial statement preparation, which one can see in the figures throughout the thesis.

These technical skills have improved my ability to work in areas like financial management and investment risk, which will help me as a professional since I am leaning more towards the path of financial advisory in the future. Along with technical skills, the critical thinking skills I have now learned are the tools that will help me succeed in the future. The knowledge I have learned within this class and throughout my college career as an accountancy student has prepared me for my future more than I can even begin to describe. I am truly thankful for how everything has evolved these past four years, the opportunities the Patterson School of Accountancy has given to their students, the teachers that have instilled their knowledge within me, and this course that has tied everything together. As for my future, I plan to take everything that I have to be thankful for (mentioned above) and put one hundred and ten percent into everything I do to make sure I am the most successful person I can be. I am extremely confident that with everything I have learned from the University of Mississippi, it won't be too hard.

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CASE I: HOME HEATERS ANALYSIS

Home Heaters Analysis is a case that takes two companies, Glenwood Heating and Eads Heaters, in the same field of business with the same first year transactions (20X1) seen in *figure 1-1*.

Home Heaters: Trial Balances and Transactions

	Cash	AR	Inventory	Land	Building	Equipment	AP	NP	Int Pay	CS	RE
No. 1	160,000.00									160,000.00	
No. 2	400,000.00							400,000.00			
No. 3	(420,000.00)			70,000.00	350,000.00						
No. 4	(80,000.00)					80,000.00					
No. 5			239,800.00				239,800.00				
No. 6		398,500.00									398,500.00
No. 7	299,100.00	(299,100.00)									
No. 8	(213,360.00)						(213,360.00)				
No. 9	(41,000.00)							(20,000.00)			(21,000.00)
No. 10	(34,200.00)										(34,200.00)
No. 11	(23,200.00)										(23,200.00)
No. 12									6,650.00		(6,650.00)
Balances	47,340.00	99,400.00	239,800.00	70,000.00	350,000.00	80,000.00	26,440.00	380,000.00	6,650.00	160,000.00	313,450.00

Figure 1-1 Home Heaters: Trial Balances and Transactions

The balances from the transactions numbered one through twelve and reflected in *figure 1-1*, are the beginning balances (Part A: Balances) for both Glenwood and Eads in their trial balances and

transactions tables (*figure 1-2, figure 1-3*). The difference, between these two identical companies is the way they record their cost of goods sold, leased equipment, income tax provision, and their allowance for doubtful accounts. These differences can be seen in their tables stated above (*figure 1-2, figure 1-3*) in the Part B transactions on the left.

Glenwood Heating: Trial Balances and Transactions

	Cash	AR	ADA	Inventory	Land	Acc. Dep-B	Building	Equipment	AP	NP	Int Pay	CS	RE
Balances: Part A	47,340.00	99,400.00		239,800.00	70,000.00		350,000.00	80,000.00	26,440.00	380,000.00	6,650.00	160,000.00	313,450.00
Part B: Bad Debts			994.00										(994.00)
Part B: COGS				(177,000.00)									(177,000.00)
Part B: Depreciation						19,000.00							(19,000.00)
Part B: Equip Rental	(16,000.00)												(16,000.00)
Part B: Income Tax	(30,914.00)												(30,914.00)
Balances	426.00	99,400.00	994.00	62,800.00	70,000.00	19,000.00	350,000.00	80,000.00	26,440.00	380,000.00	6,650.00	160,000.00	69,542.00

Figure 1-2 Glenwood Heating: Trial Balances and Transactions

Before looking at the transactions in *figure 1-3*, it is important to know that Eads Heaters uses a higher percentage for determining accounts that are not receivable, known as the allowance for bad debts. As well as using the double-declining method for salvage value of equipment. Lastly, Glenwood has a rental agreement that has better terms than Eads' in respect that Glenwood rents equipment for a price of \$16,000 a year, while Eads must payout \$128,000 over the course of eight years plus principal and interest for the leased equipment.

Eads Heaters: Trial Balances and Transactions

	Cash	AR	ADA	Inventory	Land	Acc. Dep-B	Building	Equipment	Leased Equip	Acc. Dep-Lease	AP	NP	Lease Pay	Int Pay	CS	RE
Balances: Part A	47,340.00	99,400.00		239,800.00	70,000.00		350,000.00	80,000.00			26,440.00	380,000.00		6,650.00	160,000.00	313,450.00
Part B: Bad Debts			4,970.00													(4,970.00)
Part B: COGS				(188,800.00)												(188,800.00)
Part B: Depreciation					30,000.00											(30,000.00)
Part B: Equip Lease									92,000.00				92,000.00			
Part B: Lease Payment	(16,000.00)												(8,640.00)			(7,360.00)
Part B: Lease Dep										11,500.00						(11,500.00)
Part B: Income Tax	(23,505.00)															(23,505.00)
Balances	7,835.00	99,400.00	4,970.00	51,000.00	70,000.00	30,000.00	350,000.00	80,000.00	92,000.00	11,500.00	26,440.00	380,000.00	83,360.00	6,650.00	160,000.00	47,315.00

Figure 1-3 Eads Heaters: Trial Balances and Transactions

These simple four transaction differences play a huge role in the Financial Statements of these two companies, which is visible in APPENDIX I: Financial Statements for Glenwood Heating, Inc., and in APPENDIX II: Financial Statements for Eads Heaters, Inc.

When analyzing the data presented in both companies' financial statements and looking at profitability ratios, Rutledge Consulting Group would rather invest in Glenwood Heating, Inc. for a couple of reasons. First, Glenwood has a higher net income and retained earnings when compared to Eads. Even though it shows that Eads has a greater net increase in cash in the statement of cash flows and they have more assets than Glenwood, Glenwood is using cash to pay off their liabilities better than Eads since they have a lower debt ratio (*figure 1-4*). When looking more in depth at *figure 1-4*, we see that Glenwood also has a better acid-test ratio and current ratio, which means that it is probable that Glenwood will better satisfy their liabilities (investors) when compared to Eads. Therefore, from proof in the Financial Statements and in the ratios, Glenwood Heating, Inc. is the better investment.

Profitability Ratios Data

	Glenwood Heating	Eads Heaters
Current Ratio	4.88	3.67
Acid - Test Ratio	3.02	2.57
Debt Ratio	62 %	70 %
Profit Margin	23 %	18 %
Times Interest Earned	5.34	3.23

Figure 1-4 Profitability Ratios Data

APPENDIX I: FINANCIAL STATEMENTS FOR GLENWOD HEATING, INC.

Glenwood Heating, Inc.
Income Statement
For Year Ended December 31, 20X1

Sales		\$	398,500.00
Less: Cost of Goods Sold			177,000.00
Gross Profit		\$	221,500.00
Operating Expenses			
Depreciation Expense- Building	\$	10,000.00	
Depreciation Expense- Equipment		9,000.00	
Rent Expense		16,000.00	
Bad Debt Expense		994.00	
Other Operating Expenses		34,200.00	
Total Operating Expenses	\$	70,194.00	
Operating Income		\$	151,306.00
Non-Operating Expenses			
Interest Expense	\$	27,650.00	
Total Non-Operating Expense	\$	27,650.00	
Income Before Taxes		\$	123,656.00
Provision for Taxes	\$	30,914.00	
Net Income		\$	92,742.00

Figure 1-5 Glenwood Heating: Income Statement

Glenwood Heating, Inc.
Statement of Retained Earnings
For Year Ended December 31, 20X1

Retained Earnings January 1, 20X0	\$	0
Plus: Net Income		92,742.00
Less: Dividends		23,200.00
Retained Earnings December 31, 20X1	\$	69,542.00

Figure 1-6 Glenwood Heating: Statement of Retained Earnings

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

Assets		
Cash	\$	426.00
Accounts Receivable		99,400.00
Allowance for Bad Debts		994.00
Inventory		62,800.00
Land		70,000.00
Building		350,000.00
Accumulated Depreciation- Building		10,000.00
Equipment		80,000.00
Accumulated Depreciation- Equipment		9,000.00
Total Assets	\$	642,632.00
 Liabilities		
Accounts Payable		26,440.00
Notes Payable		380,000.00
Interest Payable		6,650.00
Total Liabilities	\$	413,090.00
 Stockholder's Equity		
Common Stock		160,000.00
Dividends		23,200.00
Sales		398,500.00
Cost of Goods Sold		177,000.00
Other Operating Expenses		34,200.00
Bad Debt Expense		994.00
Accumulated Depreciation- Building		10,000.00
Accumulated Depreciation- Equipment		9,000.00
Rent Expense		16,000.00
Interest Expense		27,650.00
Provision for Income Tax		30,914.00
Total Equity	\$	229,542.00
 Total Liability and Equity	 \$	 642,632.00

Figure 1-7 Glenwood Heating: Balance Sheet

Glenwood Heating, Inc.
Statement of Cash Flows
December 20X1

Operating Activities		
Net income	\$	92,742.00
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation- Building		10,000.00
Depreciation- Equipment		9,000.00
Increase in Accounts Receivable		99,400.00
Increase in Inventory		62,800.00
Increase in Accounts Payable		26,440.00
Increase in Interest Payable		6,650.00
Allowance for Bad Debts		994.00
Net Cash provided by Operating Activities		16,374.00
Investing Activities		
Purchase of Building		350,000.00
Purchase of Equipment		80,000.00
Purchase of Land		70,000.00
Net Cash used by Investing Activities		500,000.00
Financing Activities		
Payment of Cash Dividend		23,200.00
Long-term Financing Repayment		20,000.00
Common Stock		160,000.00
Notes Payable		400,000.00
Net Cash used by Financing Activities		516,800.00
Net increase in cash	\$	426.00
Cash: January 1, 20X1		0
Cash: December 31, 20X1	\$	426.00

Figure 1-8 Glenwood Heating: Statement of Cash Flows

APPENDIX II: FINANCIAL STATEMENTS FOR EADS HEATERS, INC.

Eads Heaters, Inc.
Income Statement
For Year Ended December 31, 20X1

Sales		\$	398,500.00
Less: Cost of Goods Sold			188,800.00
Gross Profit		\$	209,700.00
Operating Expenses			
Depreciation Expense- Building	\$	10,000.00	
Depreciation Expense- Equipment		20,000.00	
Depreciation Expense- Leased Equipment		11,500.00	
Bad Debt Expense		4,970.00	
Other Operating Expenses		34,200.00	
Total Operating Expenses	\$	80,670.00	
Operating Income		\$	129,030.00
Non-Operating Expenses			
Interest Expense	\$	35,010.00	
Total Non-Operating Expense	\$	35,010.00	
Income Before Taxes		\$	94,020.00
Provision for Taxes	\$	23,505.00	
Net Income		\$	70,515.00

Figure 1-9 Eads Heaters: Income Statement

Eads Heaters, Inc.
Statement of Retained Earnings
For Year Ended December 31, 20X1

Retained Earnings January 1, 20X0	\$	0
Plus: Net Income		70,515.00
Less: Dividends		23,200.00
Retained Earnings December 31, 20X1	\$	47,315.00

Figure 1-10 Eads Heaters: Statement of Retained Earnings

Eads Heaters, Inc.
Balance Sheet
December 31, 20X1

Assets		
Cash	\$	7,835.00
Accounts Receivable		99,400.00
Allowance for Bad Debts		4,970.00
Inventory		51,000.00
Land		70,000.00
Building		350,000.00
Accumulated Depreciation- Building		10,000.00
Equipment		80,000.00
Accumulated Dep.- Equipment		20,000.00
Leased Equipment		92,000.00
Accumulated Dep.- Leased Equipment		11,500.00
Total Assets	\$	703,765.00
 Liabilities		
Accounts Payable		26,440.00
Notes Payable		380,000.00
Lease Payable		83,360.00
Interest Payable		6,650.00
Total Liabilities	\$	496,450.00
 Stockholder's Equity		
Common Stock		160,000.00
Dividends		23,200.00
Sales		398,500.00
Cost of Goods Sold		188,800.00
Other Operating Expenses		34,200.00
Bad Debt Expense		4,970.00
Accumulated Depreciation- Building		10,000.00
Accumulated Dep.- Equipment		20,000.00
Accumulated Dep.- Leased Equipment		11,500.00
Interest Expense		35,010.00
Provision for Income Tax		23,505.00
Total Equity	\$	207,315.00
Total Liability and Equity	\$	703,765.00

Figure 1-11 Eads Heaters: Balance Sheet

Eads Heaters, Inc.
Statement of Cash Flows
December 31, 20X1

Operating Activities		
Net income	\$	70,515.00
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation- Building		10,000.00
Depreciation- Equipment		20,000.00
Depreciation- Leased Equipment		11,500.00
Increase in Accounts Receivable		99,400.00
Increase in Inventory		51,000.00
Increase in Accounts Payable		26,440.00
Increase in Interest Payable		6,650.00
Allowance for Bad Debts		4,979.00
Net Cash used in Operating Activities		325.00
Investing Activities		
Purchase of Building		350,000.00
Purchase of Equipment		80,000.00
Purchase of Land		70,000.00
Net Cash used by Investing Activities		500,000.00
Financing Activities		
Payment of Cash Dividend		23,200.00
Issuance of Common Stock		160,000.00
Long term Note Payable		400,000.00
Payment of Lease Payable		8,640.00
Long-term Financing Repayment		20,000.00
Net Cash used by Financing Activities		508,160.00
Net increase in cash	\$	7,835.00
Cash: January 1, 20X1		0
Cash: December 31, 20X1	\$	7,835.00

Figure 1-12 Eads Heaters: Statement of Cash Flows

CASE II: TOTZ COMPANY REVENUES AND EXPENSES

Totz Inc. is a corporation that had a couple of different scenarios happen to them during their fiscal year in which they were confused on how to account for them in their financial statements. The scenarios include: a large increase in net sales due to services provided from Doodlez, depreciation and depletion expense calculated in gross profit, relocation of their headquarters, and a class action lawsuit with a main materials provider. To help answer their questions, Rutledge Consulting Group used the FASB Codification to help guide Totz on how to account for these four situations. Our consultation suggestions can be seen in APPENDIX III: Totz Recognition.

APPENDIX III: TOTZ RECOGNITION

- 1) In 2015, Totz had net sales of \$74.5 million and in 2016 they increased to net sales of \$86.5 million. The \$12 million-dollar increase was largely due to an increase in revenue from the services provided by Doodlez, whose net sales increased by \$7.3 million (\$3.9 million in 2015) to a total of \$11.2 million in 2016. The rest of the \$12 million increase, \$4.7 million to be exact, was due to an increase in total net sales from heightened customer response to the use of natural fibers in its garments. FASB ASC-225-10-S99-2 (b) states why Doodlez' operating service revenue is including in Totz' net sales line item, "if income is derived from more than one of the sub-captions described under § 210.5-03.1, each class which is not more than ten percent of the sum of the items may be combined with another class. If these items are combined, related costs and expenses as described under § 210.5-03.2 shall be combined in the same manner:

Net sales and gross revenues. State separately:

- a) Net sales of tangible products (gross sales less discounts, returns and allowances)
- b) operating revenues of public utilities or others
- c) income from rental
- d) revenues from services
- e) other revenues

Amounts earned from transactions with related parties shall be disclosed as required under § 210.4-08(k)."

- In 2016, Doodlez' revenue is more than ten percent of the sum of net sales, but they will still be reconciled into net sales according to § 210.3-03 "(c) If a period or periods reported on include operations of a business prior to the date of acquisition, or for other reasons differ from reports previously issued for any period, the statements shall be reconciled as to sales or revenues and net income in the statement or in a note thereto with the amounts previously reported: Provided, however, that such reconciliations need not be made (1) if they have been made in filings with the Commission in prior years or (2) the financial statements which are being retroactively adjusted have not previously been filed with the Commission or otherwise made public."
- 2) Totz had a gross profit (net sales - cost of sales) increase from \$28 million in 2015 to \$30.4 million in 2016; an increase of \$2.8 million (8.6 percent). Totz' cost of sales also increased from \$46.5 million in 2015 to \$56.1 million in 2016; an increase of \$9.6 million (20.6 percent) mainly due to an increase of cost in Doodlez' services. This cost of sales calculation includes expenses incurred to acquire and produce inventory for sale (product costs, freight-in, import costs, and direct labor costs for Doodlez employees), but does not include depreciation expenses. Therefore, Totz should not report a gross profit because it would be a subtotal that excludes a cost of sales expense (depreciation). FASB ASC-225-10-S99-8 states that "Depreciation and Depletion Excluded from Cost of Sales: if cost of sales or operating expenses exclude charges for depreciation, depletion and amortization of property, plant and equipment, the description of the line item should read somewhat as follows: "Cost of goods sold (exclusive of items shown separately below)" or "Cost of goods sold (exclusive of depreciation shown separately below)." b. To avoid placing undue emphasis on "cash flow," depreciation, depletion and amortization should not be positioned in the income statement in a manner, which results in reporting a figure for income before depreciation."

As stated above, cost of sales includes: product costs, freight-in, import costs, and direct labor costs for Doodlez employees. These costs are combined into a single class because, as also stated above in problem one, both Totz' sales revenues and Doodlez' service revenues are combined into a single line item. So therefore, to remain uniform their expenses must be combined in a single (cost of sales) line item as well, "If these items are combined, related costs and expenses as described under § 210.5-03.2 shall be combined in the same manner [ASC-225-10-S99-2 (b)]." Costs that will be combined include:

Costs and expenses applicable to sales and revenues. State separately the amount of:

- a) cost of tangible goods sold,
 - b) operating expenses of public utilities or others,
 - c) expenses applicable to rental income,
 - d) cost of services, and
 - e) expenses applicable to other revenues.
- 3) Totz moved their corporate headquarters to the beautiful city of Mountain View, California. Therefore, Totz sold the old abandoned headquarters in Oxford, Mississippi for a gain on sale of \$1.7 million. This gain on the abandoned building should be reported under operating income because according to ASC-225-20-45-1, "An event or transaction shall be presumed to be an ordinary and usual activity of the reporting entity, the effects of which shall be included in income from operations, unless the evidence clearly supports its classification as an extraordinary item." The abandoned building gain would be recorded normally as an asset, because it is not considered to be an extraordinary item as stated in ASC-225-20-45-4: "Certain gains and losses shall not be reported as extraordinary items (except as indicated in the following paragraph) because they are usual in nature or may be expected to recur because of customary and continuing business activities... d. Other gains or losses from sale or abandonment of property, plant, or equipment used in the business."
- 4) During the fiscal year of 2016, Totz was caught in a class action lawsuit with one of their fabric suppliers. The "natural material" fabric supplier was found to be not so natural, resulting in Totz gaining proceeds of \$2.7 million from the lawsuit. This \$2.7 million-dollar gain would be found under operating income in the income statement because it is considered a profit on security. ASC225-10-S99-2(7) verifies this placement in operating income:

"State separately in the income statement or in a note thereto amounts earned from:

- a) dividends
- b) interest on securities
- c) profits on securities (net of losses)
- d) miscellaneous other income.

Amounts earned from transactions in securities of related parties shall be disclosed as required under § 210.4-08(k)." Also, according to ASC-605-10-S99-1 indicates that the SEC believes the guidance in Reg S-X, Rule 5-03(b)(6) applies to both gains and losses (not just expenses or losses

CASE III: FINANCIAL STATEMENTS FOR ROCKY MOUNTAIN CHOCOLATE CO.

One of the many services we provide is financial statement preparation. This certain case shows how Rutledge Consulting Group prepares the financial statements for Rocky Mountain Chocolate Company. First, we take the journal entries that we have been logging throughout the year seen in *figure 3-1*, and post all these transactions into the trial balance (*figure 3-3*).

Journal Entries for Rocky Mountain Chocolate Co.

1) Inventory	\$ 7,500,000	
Accounts Payable		7,500,000
2) Inventory	\$ 6,000,000	
Accrued Wages		6,000,000
3) Cash	\$ 17,000,000	
Accounts Receivable	5,000,000	
Sales		22,000,000
4) Accounts Payable	\$ 8,200,000	
Cash		8,200,000
5) Cash	\$ 4,100,000	
Accounts Receivable		4,100,000
6) Sales and Marketing Expense	\$ 1,505,431	
General and Administrative Expense	2,044,569	
Retail Operating Expense	1,750,000	
Cash		2,000,000
Other Accrued Expense		3,300,000
7) Accrued Wages	\$ 6,423,789	
Cash		6,423,789
8) Cash	\$ 125,000	
Unearned Franchise Revenue		125,000
9) Property and Equipment	\$ 498,832	
Cash		498,832
10) Dividends	\$ 2,407,167	
Cash		2,403,458
Dividends Payable		3,709
11) Cost of Sales	\$ 216,836	
Inventory		216,836
12) Depreciation Expense	\$ 698,580	
Property and Equipment		698,580
13) General Administrative Expense	\$ 639,200	
Retail Operating Expense	6,956	
Accrued Wages		646,146

Figure 3-1 Journal Entries for Rocky Mountain Chocolate Co.

Then, when we have posted all the transactions from *figure 3-1*, we will close out the various revenues and expenses accounts into retained earnings, which is seen in the closing entries in *figure 3-2*. Similar to the first step, we then post these balances into the trial balance (*figure 3-3*).

Closing Entries for Rocky Mountain Chocolate Co.

1)	Sales	\$	22,944,017	
	Franchise Fees		5,925,310	
	Interest Income		27,210	
	Income Summary			3,580,077
	Cost of Sales			14,910,622
	Franchise Costs			1,499,477
	Sales/Marketing Expense			1,505,431
	General Administrative Expense			2,422,147
	Retail Operating Expense			1,756,956
	Depreciation Expense			69,858
	Income Tax Expense			2,090,468
2)	Income Summary	\$	3,580,077	
	Retained Earnings			3,580,077

Figure 3-2 Closing Entries for Rocky Mountain Chocolate Co.

When we have a completed trial balance (*figure 3-3*) with journal entries, adjustments, and closing entries we are then able to make the Financial Statements as seen in APPENDIX IV.

Rocky Mountain Chocolate: Trial Balances and Transactions

	No. 1	No. 2	No. 3	No. 4	No. 5	No. 6	No. 7	No. 8	No. 9	No. 10	No. 11	No. 12	No. 13	No. 14	Pre-Closing Trial Balance	Closing Entries	Post-Closing Trial Balance
	Feb. 28, 2009 (Begin Bal.)																
Cash	\$ 125,947.00		\$ 17,000,000.00	\$ (8,200,000.00)	\$ 4,100,000.00	\$ (2,000,000.00)	\$ (6,423,789.00)	\$ (125,000.00)	\$ (498,832.00)	\$ (2,405,458.00)	\$ 790,224.00	\$ 3,743,092.00			\$ 3,743,092.00		
Accounts Receivable	\$ 4,229,753.00		\$ 5,000,000.00								\$ (702,207.00)	\$ 4,427,526.00			\$ 4,427,526.00		
Notes Receivable	\$ -										\$ 91,859.00	\$ 91,859.00			\$ 91,859.00		
Inventory	\$ 406,611.00	\$ 7,500,000.00	\$ (14,000,000.00)								\$ (66,328.00)	\$ 3,498,283.00	\$ (216,856.00)		\$ 3,281,427.00		
Deferred Income Taxes	\$ 369,197.00										\$ 92,652.00	\$ 461,249.00			\$ 461,249.00		
Dr: Other	\$ 224,378.00								\$ 498,832.00		\$ (4,315.00)	\$ 220,163.00			\$ 220,163.00		
Property and Equipment, Net	\$ 5,253,598.00										\$ 132,859.00	\$ 5,383,289.00	\$ (698,580.00)		\$ 4,684,709.00		
Notes Receivable, less current portion	\$ 124,452.00										\$ 139,198.00	\$ 263,650.00			\$ 263,650.00		
Goodwill	\$ 1,046,944.00										\$ 1,046,944.00	\$ 1,046,944.00			\$ 1,046,944.00		
Intangible Assets	\$ 183,135.00										\$ (73,110.00)	\$ 110,025.00			\$ 110,025.00		
Other	\$ 91,057.00			\$ (8,200,000.00)							\$ (3,007.00)	\$ 88,050.00			\$ 88,050.00		
Accounts Payable	\$ 1,074,643.00	\$ 7,500,000.00					\$ (6,423,789.00)				\$ 935,189.00	\$ 873,821.00			\$ 873,821.00		
Accrued Wages	\$ 423,789.00													\$ 646,146.00			
Other Accrued Expenses	\$ 531,941.00					\$ 3,300,000.00					\$ (2,885,413.00)	\$ 946,528.00			\$ 946,528.00		
Dividend Payable	\$ 598,986.00									\$ 3,709.00	\$ (1.00)	\$ 60,940.00			\$ 60,940.00		
Deferred Income	\$ 142,000.00							\$ 125,000.00			\$ (46,062.00)	\$ 200,938.00			\$ 200,938.00		
Deferred Income Taxes	\$ 827,700.00										\$ 66,729.00	\$ 894,290.00			\$ 894,290.00		
Common Stock	\$ 179,696.00										\$ 1,112.00	\$ 180,808.00			\$ 180,808.00		
Additional Paid-in Capital	\$ 7,311,280.00										\$ 315,322.00	\$ 7,626,602.00			\$ 7,626,602.00		
Retained Earnings	\$ 5,751,017.00									\$ (2,407,167.00)	\$ 3,343,850.00	\$ 3,343,850.00			\$ 3,343,850.00	\$ 3,380,077.00	\$ 692,927.00
Salts	\$ -		\$ 22,000,000.00								\$ 944,017.00	\$ 22,944,017.00			\$ 22,944,017.00	\$ (2,944,017.00)	\$ -
Franchise and Royalty Fees	\$ -										\$ 5,492,531.00	\$ 5,492,531.00			\$ 5,492,531.00	\$ (5,492,531.00)	\$ -
Cost of Sales	\$ -		\$ 14,000,000.00								\$ 693,786.00	\$ 14,693,786.00	\$ 216,856.00		\$ 14,910,622.00	\$ (14,910,622.00)	\$ -
Franchise Costs	\$ -										\$ 1,499,477.00	\$ 1,499,477.00			\$ 1,499,477.00	\$ (1,499,477.00)	\$ -
Sales and Marketing	\$ -					\$ 1,585,631.00					\$ 1,499,477.00	\$ 1,894,770.00			\$ 1,894,770.00	\$ (1,894,770.00)	\$ -
General and Administrative	\$ -					\$ 2,044,569.00					\$ (26,162.00)	\$ 1,782,947.00		\$ 69,200.00	\$ 2,422,147.00	\$ (2,422,147.00)	\$ -
Retail Operating	\$ -					\$ 1,750,000.00					\$ (26,162.00)	\$ 1,750,000.00		\$ 6,956.00	\$ 1,756,956.00	\$ (1,756,956.00)	\$ -
Depreciation and Amortization	\$ -													\$ 698,580.00	\$ (698,580.00)	\$ -	
Interest Income	\$ -										\$ (27,210.00)	\$ (27,210.00)			\$ (27,210.00)	\$ 27,210.00	\$ -
Income Tax Expense	\$ -									\$ 2,090,488.00	\$ 2,090,488.00	\$ 2,090,488.00			\$ 2,090,488.00	\$ (2,090,488.00)	\$ -

Figure 3-3 Rocky Mountain Chocolate: Trial Balances and Transactions

APPENDIX IV: ROCKY MOUNTAIN CHOCOLATE COMPANY FINANCIAL STATEMENTS

**Rocky Mountain Chocolate Company
Income Statement**

For Year Ended February 2010

Sales	
Sales	\$ 22,944,017.00
Franchise and Royalty Fees	5,492,531.00
Net Sales	\$ 28,436,548.00
 Cost and Expenses	
Costs of Sales	14,910,622.00
Franchise Costs	1,499,477.00
Sales and Marketing Expense	1,505,431.00
General and Administrative Expense	2,422,147.00
Retail Operating Expense	1,756,956.00
Depreciation and Amortization	698,580.00
Total Costs and Expenses	\$ 22,793,213.00
 Operating Income	 \$ 5,643,335.00
 Other Income (Expense)	
Interest Income	27,210.00
Other, net	27,210.00
 Income Before Income Taxes	 5,670,545.00
Income Tax Expense	2,090,468.00
Net Income	\$ 3,580,077.00
 Basic Earnings per Common Share	 \$ 0.60
 Diluted Earnings per Common Share	 \$ 0.58
 Weighted Average Common Shares Outstanding	 \$ 6,012,717.00
Dilutive Effect of Employee Stock Options	\$ 197,521.00
 Weighted Average Common Shares Outstanding, Assuming Dilution	 \$ 6,210,23.00

Figure 3-4 Rocky Mountain Chocolate: Income Statement

Rocky Mountain Chocolate Company
Balance Sheet
February 28, 2010

Assets	
Current Assets	
Cash	\$ 3,743,092.00
Accounts Receivable	4,427,526.00
Notes Receivable, current	91,059.00
Inventories	3,281,447.00
Deferred Income Taxes	461,249.00
Other	220,163.00
Total Current Assets	\$ 12,224,536.00
Property and Equipment, net	\$ 5,186,709.00
Other Assets	
Notes Receivable, less current portion	\$ 263,650.00
Goodwill, net	1,046,944.00
Intangible Assets, net	110,025.00
Other	88,050.00
Total Other Assets	1,508,669.00
Total Assets	\$ 18,919,914.00
Liabilities and Stockholders' Equity	
Current Liabilities	
Accounts Payable	877,832.00
Accrued Wages	646,146.00
Other Accrued Expenses	946,528.00
Dividend Payable	602,694.00
Deferred Income	220,938.00
Total Current Liabilities	3,294,138.00
Deferred Income Taxes	894,429.00
Stockholders' Equity	
Common Stock, \$0.3 par value; 100,000,000 shares authorized; 6,026,938 and 5,989,858 shares issued and outstanding, respectively	180,808.00
Additional Paid-In Capital	7,626,602.00
Retained Earnings	6,923,927.00
Total Liabilities and Owner's Equity	\$ 18,919,914.00

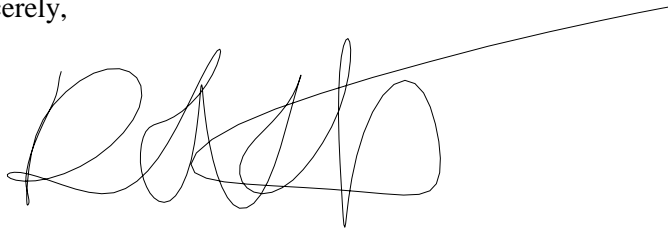
Figure 3-5 Rocky Mountain Chocolate: Balance Sheet

CASE IV: INTERNAL CONTROL SUGGESTIONS FROM THE CONSULTING GROUP

Dear Kayla,

Thank you for hiring the Rutledge Consulting Group, LLC. We have evaluated your operations and have identified areas where fraud might occur. Along with these identified areas, we have provided our recommendations of internal control that will help eliminate these possibilities of fraud. Please see our recommendations in *figure 4-1*.

Sincerely,

A handwritten signature in black ink, appearing to read 'Rachel Rutledge', with a long horizontal line extending from the end of the signature towards the right side of the page.

Rachel Sidney Rutledge
Rutledge Consulting Group, LLC.

Controls Table

Problem Susceptible to Fraud	Recommended Control
Lucy records daily sales and prepares the corresponding bank deposits.	You should implement a segregation of duties so there is a different person recording sales and making money deposits.
While the automatic update of the perpetual inventory system is efficient, not verifying the physical inventory count to the perpetual inventory count on the books is a problem.	Have another employee conduct a physical inventory count weekly and report any discrepancies between the count and the recorded book value.
Lucy has access to the accounting system, even though she oversees making money deposits.	There should be a segregation of duties so a different person handles the accounting system than the one who makes money deposits.
While the unique code is a start for preventing unauthorized access to the registers, it is susceptible to theft by another employee.	Add another control measure by requiring employees to swipe a provided employee key card in addition to the unique employee code. Such a control will help prevent unauthorized or fraudulent access to the registers.
You are monitoring the perpetual inventory records and ordering inventory.	Instead of this, have your employee in charge of taking a physical inventory count provide you with the inventory on hand, upon which you order the required inventory needed.
You are taking the deposits to the bank and reconciling the bank statements.	These duties should be separated, as the same person doing both duties opens the door to fraud as well as tainting the independence of the reconciler.
No checks or reconciliations of daily transactions	While autonomy of the employees is important, you or Lucy should check the validity of every transaction, as well as reconcile the transactions with the cash on hand.

Figure 4-1 Controls Table

CASE V: INVENTORY MORE IN-DEPTH

This case provides a more in-depth look at a manufacturing company that takes raw materials, transfers them into work in process inventory, and then into finished goods that are available for sale. In APPENDIX V: Inventory Questions, we provide more of an explanation and give answers to some basic inventory questions to help the client understand how all the accounts are connected. We also provide t-account data (*figure 5-1 in APPENDIX V*) that offers a visual with to help understand the values that inventory can take and how we account for those values.

APPENDIX V: INVENTORY QUESTIONS

- 1) Inventory consists of raw materials, work-in-process, and finished goods. Raw materials inventory includes the costs of the materials that go into the product that have not been transformed into work-in-process or finished goods inventory. An example of a raw material cost would be direct materials. Work-in-process includes the costs of direct labor and manufacturing overhead costs, basically the costs of transforming the materials into the finished good. Finished goods inventory includes the costs that occur after the product is finished. For example, finished goods would include the selling costs and market costs that relate to the finished product.
- 2) The inventories are net of an estimated allowance for inventory that are 'obsolete' or 'unmarketable.' This estimation is based on current inventory levels, trends in sales, and estimates made by upper level managers about the current market conditions and their forecasts of future product demand.
- 3)
 - a) Since inventories are recorded as 'net' of the estimated allowance for obsolete and unmarketable inventory, I believe that the estimated account will be listed directly under inventory as a contra account if the company chooses to disclose it. If the company does not directly disclose the account on the financial statement, then the inventories will be listed as a net balance.
 - b) The gross amount of inventory for 2011 would be 243,870.00 and the gross amount of inventory for 2012 would be 224,254.00. Since inventory is recorded net of the estimated allowance; I added the beginning balance in the estimated allowance account to 2011 inventory, and the ending value in the estimated allowance account to the 2012 inventory to get the gross amounts.
 - c) I believe that most of the portion of the reserve for obsolete inventory is attributable to the finished goods inventory, because it is mainly based on market conditions and future product demand and that relates to the goods that have already been finished.

4) Journal Entries

Obsolete Inventory Expense	\$	13,348.00	
Allowance for Obsolete Inventory			13,348.00
<i>To record the provision</i>			
Allowance for Obsolete Inventory	\$	11,628.00	
Finished Goods Inventory			11,628.00
<i>To record write-offs, disposals, and other</i>			

5) **T-Account Data**

Raw Materials		Work-in-Process		Finished Goods		Cost of Sales		Accounts Payable	
\$46,976		\$ 1,286		\$184,808			\$ 0		\$ 39,012
438,561		126,000			13,348	13,348			438,561
			568,735	568,735					
	442,068	442,068			572,549	572,549		432,197	
\$43,469		\$ 619		\$167,646		\$585,897			\$45,376

Figure 5-1 T-Account Data

- a) Cost of finished goods sold: 572,549.00
- b) Cost of finished goods transferred: 568,735.00
- c) Cost of raw materials transferred: 442,068.00
- d) Cost of raw materials purchased: 438,561.00
- e) Cash disbursed for raw material purchases: 432,197.00

6) **Inventory Turnover Ratio**

- a) 2012: 1.317
- b) 2011: 1.147

7) **Inventory Holding Period**

- a) 2012: 277.15
- b) 2011: 318.22
- c) The company is becoming more efficient, because in 2011 (prior year) it took them an estimated 319 days to manufacture and sell inventory but in 2012 (current year) they decreased the amount of days to manufacture and sell inventory to 278 days.

8) **Percent of Obsolete Inventory to Finished Goods**

- a) 2012: 7.96%
- b) 2011: 6.29%
- c) As an investor, I would also like examine other financial ratios that look at other parts of the company like the assets and liabilities or debt-to-equity ratios. Other than just examining the ratios that must deal with inventory

CASE VI: WORLDCOM INC. – CAPITALIZED COSTS AND EARNINGS

Our client, WorldCom Inc. capitalizes line costs, due to the greater risk they carry of not having enough line capacity available for when customers need to call. These line costs are capitalized throughout the year and expensed when they match revenues (Appendix VI provides a better description). To help our client, Rutledge Consulting Group looked at WorldCom's depreciation expense for these leased line costs and then plugged it into their net income, to help show them where they went wrong and how to better themselves for the future. Our consultation results can be seen in APPENDIX VI: WorldCom Line Costs.

APPENDIX VI: WORLDCOM LINE COSTS

- 1) FASB Statement of Concepts No. Six
 - a) FASB defines assets as an item that a company has control over and control over its potential future benefits, therefore the asset must provide future benefits for the company. The asset is a result of a past transaction or event. An expense is defined as an outflow of either using up an asset (accumulated depreciation) or increasing a liability (accounts payable). The expense outflows must be for business operations like producing goods, purchasing goods, rendering services, or misc. expenses for business operations. Assets generate revenue, while expenses are costs incurred through generating income.
 - b) Costs that are incurred to achieve greater future benefit from the asset should be capitalized, while expenditures that maintain a level of service should be expensed. For a cost to be capitalized, one of three conditions must take place:
 - The useful life of the asset must be increased.
 - The quantity of service produced from the asset must be increased.
 - The quality of the units produced must be enhanced.

So basically, cost that is relevant and matches to revenue in that certain period should be expensed and it should also be capitalized if it is generating a resource for future benefits.

- 2) When costs are capitalized, they normally relate to the long-term assets like property, plant, and equipment. These long-term assets include the all the costs associated with the asset, for example leveling and clearing the land for a new project or razing a building to build a new warehouse all go into the cost of the land. When an expenditure is capitalized, it increases the fixed (long-term) asset. The inverse effect of increasing the fixed assets is that the interest expense decreases because instead of fully recognizing all the interest, we are adding it to the cost of the long-term asset. This decrease in an expense increases net income on the income statement.
 - a) WorldCom reported line costs of \$14,739,000 for the year ending December 31, 2001. For communication firms like WorldCom, the threat of insufficient line capacity is a normal occurrence. Therefore, companies will use lines of other firms to complete the calls for their customers (taking away the threat of insufficient line capacity). This expense of using another firm's line is like a prepaid or rental fee, because the firms agree to a contract and terms for the use of lines. So, the charges will be expensed out in the year when the lines are used. Line costs mainly include access charges and line charges.

Journal Entry:

Line Costs	\$	14,739,000	
Accounts Payable			14,739,000
<i>To record the accrual of line costs</i>			

- b) Line costs to lease the lines from other companies were capitalized because when the lines are not being leased they are not generating revenue, so they would be capitalized now and then when they are used they will be expensed to match the lease revenue. The line costs arise from the lease contracts from other firms and when they had more unused lines, management decided to capitalize the unused line costs and amortize over the future periods. These costs do not match the definition of an asset from FASB concept no. six because the costs are rental charges for a current period, not for a future period.
- c) The costs are located under the property and equipment section in the balance sheet as a capital investment. In the statement of cash flows, these capitalized costs are in the investing activity section as additions in capital investment.

Journal Entry:

Property and Equipment	\$	3,055,000	
Cash			3,055,000
<i>To record the capital investment</i>			

d) Depreciation Expense Calculations for 2011:

Quarter #1: \$ 771 million/22 years x 4/4	\$	35,045,000
Quarter #2: 610 million/22 years x 3/4		20,795,000
Quarter #3: 743 million/22 years x 2/4		16,886,000
Quarter #4: 931 million/22 years x 1/4		10,580,000
Total Depreciation	\$	83,306,000

Journal Entry:

Depreciation Expense	\$	83,306,000	
Accumulated Depreciation			83,306,000
<i>To record depreciation expense</i>			

e) WorldCom Estimated Net Income for 2011:

Stated Net Income for 2011:	\$	1,501,000
Line Costs Capitalized		3,055,000
Depreciation		83,306
Net Line Costs	\$	2,971,694
35% Tax Liability		1,040,093
Total income inflated	\$	1,931,601

Estimated Net Loss 2011: \$ 430.691 million. Therefore, the difference in net income is material.

- f) Management at WorldCom could have had a couple of incentives to deferring the line costs. One reason is that management had contracted plans to expand the transmission system to complete the calls of customers. Therefore, this increase in cost and investment is higher than the revenue generated by expanding the system, which is inefficient. So, management tried to highlight that they had a “grow-at-any-cost” culture by hiding the inefficiencies from investors. Also, management could have been trying to smooth income, stabilize stock price, use the increased income for other purposes or for increasing stock reward.
- g) Some internal controls that WorldCom should have put in place to detect and prevent this improper accounting include:
- Having a board or group of directors that set a certain level for a capitalization limit, and then any amounts that increase the amount over the limit should be approved and assessed.
 - Instead of having a lot of smaller fixed assets, reduce the number so that there is a better way to manage the ones you do have.
 - There should be an automated reporting system or control that should report transactions that are capitalized above said limits.
 - Reviewal of capital accounts and expenditures to see if there are any unusual trends or drastic changes.
- h) Some consequences of being known as a fraudulent company in the publicly traded market:
- In this certain case for WorldCom their stock price fell from \$64 to less than a dollar after their scandal became news. Their stock price decrease also effected the stock exchange because their investors and shareholders accrued a huge loss.
 - Fraudulent acts decrease the confidence of investors.
 - A company can lose a lot of their profit or even go bankrupt, which is what happened to WorldCom. This put a lot of employees out of work.
 - Not only do investors realize losses, but also the employees working for the company suffer from financial losses based on retirement plans.

CASE VII: TARGA COMPANY – BENEFITS AND RETRAINING

Our client, Targa Company, is restructuring one of its business lines. As a result of this restructuring, Targa is relocating its manufacturing warehouse to a new location in a different region. With this relocation comes the termination of 120-125 employees, in which Targa reciprocated with a termination benefit plan that will cost the company \$2.5 million for termination benefits, \$500 thousand for severance pay, and \$50 thousand for the terminated managers bonuses. With our help, we have provided Targa a way to account for both the employee termination benefits and for the retraining and relocation costs associated with the move to a new geological region in their fiscal year-end financial statements, which can be seen in APPENDIX VII: FASB Codification Findings for Targa.

APPENDIX VII: FASB CODIFICATION FINDINGS FOR TARGA

- 1) Employee Benefits: A situation to be considered for employee termination benefits should meet all the requirements as stated in ASC 420-10-25-4:
 - 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 location, 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 employee 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.”

In Appendix A, Targa has already stated the reduction of 140 engineering, facility management, and operational management employees at Plant A in Brooklyn Park by the date of January 31, 2018. So since they have met all of the requirements and it is stated in Appendix A that, “Receipt of the one-time termination benefit is contingent on continued service through the date the Company closes the facility” Targa can classify this as a one-time employee termination of benefits and therefore they can record this at fair value according to ASC 420-10-30-5: “If employees are not required to render service until they are terminated in order to receive the termination benefits or if employees will not be retained to render service beyond the minimum retention period, a liability for the termination benefits shall be measured at its fair value at the communication date.”

Also, the case states that in accordance with the facility manager’s employment agreement that manager will receive an additional lump sum benefit of \$50,000. This lump sum benefit is defined as a ‘contractual termination benefit’ and therefore according to ASC 712-10-25-2 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. The cost of termination benefits recognized as a liability and a loss shall include the amount of any lump sum payments and the present value of any expected future payments.” So therefore, the \$2,500,000 and the \$500,0000 severance will be considered as a liability for 2017.

- 2) Retraining and Relocation Costs: ASC 420-10-05-01 states that: “An exit activity includes but is not limited to a restructuring cost. These costs include:
 - a) Involuntary employee termination benefits pursuant to a one-time benefit arrangement.
 - b) Costs to terminate a contract that is not a lease.
 - c) Other associated costs, including costs to consolidate or close facilities and relocate employees (05-02).”

Therefore, according to ASC 420-10-25-15 “The liability shall not be recognized before it is incurred, even if the costs are incremental to other operating costs and will be incurred as a direct result of a plan. A liability for other costs associated with an exit or disposal activity shall be recognized in the period in which the liability is incurred.” So therefore,

the relocation costs of \$500,000 and the staff retraining costs of \$1.5 million should not be included in the financial statements for the year end of December 31, 2017 but rather when they are incurred over the next.

CASE VIII: MERCK AND COMPANY STOCK

Our client, Merck and Company, is a large pharmaceutical company whose shares are listed on the New York and Philadelphia Stock Exchanges. Merck operates under U.S. GAAP policies, which differ from the IRS based on some aspects pertaining towards stock. Also, Merck uses the cost method when accounting for treasury stock. APENDIX VIII: Merck Common Stock and Dividends, shows the effect of the cost method and answers more basic questions about how Merck accounts for their common stock under the GAAP method.

APPENDIX VIII: MERCK COMMON STOCK AND DIVIDENDS

- 1)
 - a) Merck is authorized to issue 5.4 billion shares in 2007.
 - b) Merck issued 2,983.508 million shares at December 31, 2007.
 - c) The 2,983.508 million shares come out to being 29.8 million in common stock because of the one cent par value.
 - d) 811,005,791 common shares are held in Treasury at December 31, 2007.
 - e) 2,172.502 million common shares are outstanding at December 31, 2007.
- 2) Many firms that do not need to reinvest money back into their company issue out dividends because it increases shareholder want in their company when they see that a company has dividend and therefore a positive future. This positive future increases the demand in the stock and therefore increases the prices.
- 3) A company buys back their own shares “repurchase” because it decreases the total assets and therefore causing its return on assets and return on equity improve or increase. Since repurchase also reduces the number of shares outstanding, a company can then improve their earnings per share as well.
- 4) **Journal Entry:**

Retained Earnings	3,307.3
Dividends Payable	3,307.3

To record the dividends
- 5)
 - a) Merck uses the cost method to account for Treasury Stock, therefore they treat it as a temporary deduction in stockholder’s equity (not a retirement of shares).
 - b) They repurchased 26.5 million shares.
 - c) In total, the cost was \$ 1,429.7 million to repurchase the shares and the price per share was \$53.95. This is a financing cash flow.
 - d) Since Merck repurchases its own stock it is a contra equity account that reduces shareholder equity on the balance sheet, because it would be illegal to treat it as an asset since it is their own stock and you cannot make a profit on your own stock.
- 6) The differences in the two ratios of 2007 and 2006 show that the dividend payout significantly increased in 2007 which show higher returns for investors but not stable overall. Then the dividend to assets, dividends to operating cash flows, and dividend yield ratios all dropped in 2007 from 2006.

Merck and Company Dividends (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 (dividends per share to stock price)	2.64 %	3.65 %
Dividend payout (dividends to net income)	1.01	0.75
Dividends to total assets	6.84 %	7.45 %
Dividends to operating cash flows	47.25 %	49.11 %

Figure 8-1 Merck and Company Dividends

CASE IX: XILINX INC. STOCK COMPENSATION

Our client, Xilinx Inc., has different stock compensation offers they give to their employees.

This case (APPENDIX IX: Stock Plans) shows how to account for these different options and more about the general accounting rules for them.

APPENDIX IX: STOCK PLANS

- 1) Stock option plans are used by companies that want to compensate, retain, and attract employees. These plans are like contracts between a company and employee in which it gives the holder the right to purchase a share of common stock at a pre-set price (exercise price) over a certain period. Stock options can be granted a certain period but employees aren't allowed to exercise the stock until the vest date, so there is a service period in between that we must account the compensation for. The plus for employees is that they have the option to buy stock at the exercise price for a set period.
- 2) Restricted Stock plans are when companies' issues shares of restricted stock to employees, these restricted shares cannot be sold until vesting occurs. So, if an employee leaves before the end of the vesting period then they should give up all the shares and return them to the company. The positives with restricted stock include: they never become completely worthless, it better aligns the employee incentives with company incentives. They offer both based on risk of the employee, because if an employee has more risk they would give the stock option or shorter period compensation plan compared to the RSU that is more long term.
- 3)
 - a) Grant Date: is the date that an employee receives a stock option.
 - b) Exercise Price: is also known as the strike price is the price at which a security can be purchased by an employee, this price is a special price that the company issued to the employee and it is lower than the fair value so that way when they purchase the shares at the exercise price they can sell them for a higher price on the market.
 - c) Vesting Period: Is the period for restricted stock in the sense that it is the time between grant date and the vesting date and it is the time they have before the stocks are given to the employee.
 - d) Expiration Date: expiration date is the time that the stock option offer expires for the employee so they basically have from the vesting date to the expiration date to purchase the stocks at the exercise price.
 - e) Options/RSUs granted: RSUs granted means that these are how many restricted stock options that the company has given out.
 - f) Options Exercised: options exercised mean that the employee has chosen to purchase the stock.
 - g) Options/RSUs forfeited or cancelled: these represent stock that is returned the company because an employee left the company prior to the vesting period being over of the restricted stock, so therefore they do not receive their restricted shares and the shares go back into common stock.
- 4) Basically, under the company's ESPP plan an employee has the right to purchase common stock in the company at the end of each six-month exercise period. They can use 15 percent of their annual earnings up to \$21 thousand in a year. The incentive for this is that the price of the stock is 85 percent lower than the fair market value at the beginning of the offering period or at the end of the six-month exercise period, so therefore they can purchase the stock at the beginning and then resell the stock for higher. This also why it differs because they are guaranteed that it will be 85 percent lower, and with stock options and RSUs there is no guarantee. It also

differs from RSU and stock option plans it is an extremely short period compared to longer periods like 3 to 5 years, while this is 6 months to 24 months.

- 5) The company must account for the compensation during the grant date and the vesting date so in-between the period that they grant the option to the employee until the day that it becomes available to said employee. They account for it during this period by using the straight-line method to allocate the costs per year. During this time, the compensation expense is debited while Paid in Capital-stock options is credited, this PIC account is a contra equity account. Whenever an employee decides to exercise rights whenever it is past the vesting date then they account for that by debiting cash and PIC-stock options and debiting common stock (for the par value and number of shares exercised) and PIC-ex par on common.
- 6)
 - a) The report shows \$ 77,862,000 in stock based compensation on income before taxes.
 - b) Xilinx Co. accounts for these stock options by debiting three non-cash accounts: cost of goods sold, R and D expense, SG and A expense and then crediting additional paid in capital for stock options.
 - c) Since the tax expense is not actually paid in cash yet, Xilinx adds the tax expense back into the statement of cash flows, which is seen in the operating section of the statement “tax benefit from stock based compensation.”
 - d) The compensation expense is not deducted into the stocks are paid out at the vesting date, so then the tax is paid whenever the stocks are paid out and it reduces the deferred tax asset that was created “tax benefit from stock based compensation.”

Journal Entry:

Income Tax Expense	XXX	
Income Tax Payable		XXX
<i>To record income tax expense</i>		

e) **Journal Entry:**

Cost of Goods Sold	\$	6356	
R&D Expense		37937	
SG&A Expense		33569	
APIC-Stock Options			77862

- 7)
 - a) The article discusses that there has been a shift in stock options to restricted stocks. Based on the article, it suggests that restricted stock options are becoming increasingly more popular because they have better benefits associated with them. I believe that employees prefer this because of the benefits: they never become worthless (or the options never do) so it is less risk, they result in less dilution, and it better aligns employee incentives with the company’s incentives by providing a longer-term perspective.

- b) The graph shows that in 1999 stock options were 78 percent of the long-term compensation package. Today, stock options are only 30 percent. This shift in use from stock options to restricted stocks has been seen also in Xilinx since they have gone from granting 2,345 stock options in 2010 to just 92 in 2012. The number of RSUs has increased significantly from 2043 in 2010 to 3018 in 2012. So yes, Xilinx has followed this trend in switching from being stock optioned based to offering more restricted stock compensations.

CASE X: BIER HAUS REVENUE

Part I:

Step 1: Identify the contract with a customer; the contract is between the Bier Haus and the college student that is buying the beer.

Step 2: Identify the performance obligations in the contract; the performance obligation in this situation is the beer that the college student receives.

Step 3: Determine the transaction price; the transaction price is the price of the beer or in this case the \$5.

Step 4: Allocate the transaction price to the performance obligation; the \$5 is allocated to the obligation of Bier House giving the college student the beer.

Step 5: Recognize revenue when performance obligation is satisfied; the college student is instantaneously satisfied when he receives the beer so revenue is recognized.

Journal Entry:

Cash	\$	5	
Sales Revenue			5
<i>To record sales revenue</i>			

Part II:

Step 1: Identify the contract with a customer; the contract is Bier Haus transferring the mug and the beer to the student.

Step 2: Identify the performance obligations in the contract; the performance obligation in this situation is the beer and the mug that the college student receives but they are considered separate because they are distinct in the fact that the student can benefit from the goods together or on their own and that the good is separately identifiable from other promises in the contract.

Step 3: Determine the transaction price; the transaction price is the price of the beer and the mug so in this case the beer and the mug that cost the student \$7.

Step 4: Allocate the transaction price to the performance obligation; we allocate the prices based on the relative sales model so the total for the two is \$8 so we take 3/8 (mug) x 7 and then 5/8 x 7 (beer). We multiply by \$7 because that is the transaction price the student paid but the \$8 is the actual value of the products.

Step 5: Recognize revenue when performance obligation is satisfied; the college student is instantaneously satisfied when he receives both the beer and the mug so revenue is recognized.

Journal Entry:

Cash	\$	7	
Sales Revenue-Mugs			2.62
Sales Revenue-Beer			4.38
<i>To record sales revenue</i>			

Part III:

Step 1: Identify the contract with a customer; the contract is Bier Haus transferring the beer to the student and giving the student a coupon for the pretzels and the coupon passes the necessitates to be deemed as a contract because since the coupons are sold the Bier Haus expects the coupons to be used by the student because they regularly give them out to increase visits and it stated that they are always redeemed.

Step 2: Identify the performance obligations in the contract; the performance obligation in this situation is the beer and the mug that the college student receives and to redeem the coupon for two pretzels later period.

Step 3: Determine the transaction price; the transaction price is the price of the beer and the pretzel coupon so in this case the beer and the coupon cost the student \$7.

Step 4: Allocate the transaction price to the performance obligation; since he sold the coupon to the student for \$2 instead of giving it to him for \$3.50 there is a discount to recognize because it was given to the student as a failure to perform the obligation of giving the student a pretzel.

Step 5: Recognize revenue when performance obligation is satisfied; the college student is instantaneously satisfied when he receives the beer and the coupon will be satisfied when the student redeems it later so it is unearned revenue (the dates can be different because it is for two pretzels so he could get both pretzels at the same time or at different times).

Journal Entry:

Cash	\$	7	
Unearned Pretzel Revenue			2
Sales Revenue-Beer			5

To record and accrue services

Part IV:

Step 1: Identify the contract with a customer; the contract is Bier Haus accepting the coupon as payment for the pretzel.

Step 2: Identify the performance obligations in the contract; the performance obligation here is giving the student the two pretzels.

Step 3: Determine the transaction price; since the coupon is an unearned revenue and the value of the coupon is \$3.50 then they recognize \$3.50 in Pretzel revenue.

Step 4: Allocate the transaction price to the performance obligation; the \$3.50 is the price that the company sells the coupons for so that is what they will recognize.

Step 5: Recognize revenue when performance obligation is satisfied; the college student is instantaneously satisfied when he receives the two pretzels and therefore revenue is recognized.

Journal Entry:

Unearned Pretzel Revenue	\$	3.5	
Sales Revenue- Pretzels			3.5

To recognize revenue

CASE XI: ZAGG INC. DEFERRED TAX ASSETS AND LIABILITIES

Income Tax Accounting and Financial Statement Accounting give rise to differences called deferred tax assets or liabilities. These differences can either be temporary or permanent, which are then accounted for based on their properties. APPENDIX XI: DTA and DTL, tells more about these differences and uses our client, Zagg Inc's data to help answer some more questions about the topic.

APPENDIX XI: DTA AND DTL

- 1) Book income is the income that is reported in financial statements of the taxable entity. So basically, taxable income is normally not listed with financial income (book income) and it is the income before tax. A company's book income differs from its taxable income because book income is found using the accrual method, while a tax return uses a modified cash method. The number in ZAGG's statement of operations that shows book income is \$ 23,898 thousand.
- 2)
 - a) Permanent tax differences: a permanent difference is a business transaction that is reported differently for both financial and tax purposes. The difference that completely reduces the tax liability of the business is the key goal. An example of this is meals and entertainment so they are partially recognized.
 - b) Temporary tax differences: this is a difference in the carrying amount or fair value of an asset or liability and its tax base. The temporary difference can either be taxable or deductible. An example of this is finding depreciation in either straight line for the books and an accelerated method for tax purposes.
 - c) Statutory tax rate: Statutory tax means a legally imposed rate. Income tax has different statutory rates for different levels of income, while sales tax is a flat rate.
 - d) Effective tax rate: it is the average rate at which their earned income is taxed. It is found by dividing the total tax expense by earned taxable income.
- 3) Deferred income taxes create an asset in the sense that it creates future value by taking extra money from the tax difference into the account somewhat like a prepaid account and therefore even though you do not owe the tax today you eventually must owe the tax in the future. Companies don't report their current tax bill as their income tax expense because this asset creates future value and therefore they are saving money to pay for future taxes.
- 4) Deferred tax assets are when the company has paid their taxes early or has paid too much tax and it creates a future value of money that they get back from tax authorities. A situation where this arises is when a company gets a tax loss and then they push forward the loss to then reduce taxable income in future years.
Deferred tax liabilities are taxes that a company would have had to pay under regular accounting but that it has deferred to be paid in the future. So, if a company has a profit of \$3000 and they can push the profit into the next year so that they do not have to pay the 30 percent tax on the profit and then it creates a \$900 tax liability.
- 5) A company creates an allowance for the tax asset when there is more than a 50 percent probability that the company will not realize some portion of the asset. The need for this account arises if a company has had a past of letting these unused carry forwards expire or when they think they will have a loss in the next few years. This allowance account fully offsets the deferred tax assets.

6)

a) **Journal Entry:**

Income Tax Expense	\$	9,393	
Net Deferred Tax Asset		8,293	
Income Taxes Payable			17,686
<i>To record deferred tax asset</i>			

b) **Journal Entry:**

Income Tax Expense	\$	9,393	
Deferred Tax Asset		8,002	
Deferred Income Tax Liability		291	
Income Tax Payable			17,686
<i>To allocate the tax liability and asset</i>			

c) **Effective Rate:** $9393/23898 = 39.30\%$

The statutory rate is just the 35 percent (federal rate) on the taxable income and therefore it is $8364/23898$, while the effective rate uses the entire income tax expense of 9393 (including federal tax) divided by the income before taxes.

d) On the balance sheet, this amount of \$13,508,000 is found in both current assets and non-current assets. The amount of 6,912 for deferred income tax assets in current plus the amount of deferred income tax assets non-current of 6,596 equals a total of 13,508.

CASE XII: BUILD-A-BEAR LEASED ASSETS

This case considers hypothetical leases for our client, Build-A-Bear workshop to determine which lease would be the best option for them to chose for the future. APPENDIX XII: Build-A-Bear Options, describes the different leases in-depth and then statistically shows which lease option they should continue with.

APPENDIX XII: BUILD-A-BEAR OPTIONS

- 1) Companies lease assets for a couple of reasons. One reason on why they do this is because the tax benefits are greater since the lease payments can be fully deducted in the year that one pays them. Leases are also more flexible based on our ever so changing technology market. Also, leasing assets gives a business lower start-up costs compared to completely buying the equipment.
- 2) An operating lease is the rental of an asset from a lessor, but not under terms that would classify it as a capital lease. A capital lease is a lease in which the lessor only finances the lease, and all the other rights of ownership transfer to the lessee (record asset as the lessee's property in the general ledger. A direct-financing lease combines a sale and financing transaction, so therefore the lessor records a sale on its books and removes the asset from the books and replaces it with a receivable from the lease. During the lease, the lessor gets interest income. Lastly, a sales type lease receives the same accounting as the direct financing lease except that the profit of the sale is recognized at the inception date of the lease and so is the interest income received.
- 3) Accountants do this to give clients a better reliable view of the financial statements for a certain business based on the terms of the lease (different terms for different leases).

4)

- a) According to Note 10, the lease will be treated as an operating lease because payments expire at various dates throughout the agreement. And the title is never transferred to Build-A-Bear.

b) **Journal Entry:**

Lease Payment	\$	100,000
Cash		
100,000		

To record payment of the lease

c) **Journal Entries:**

(a) Year 1: No Entry

(b) Year 2- 5:

Lease Payment	\$	125,000
Cash		
125,000		

To record payment of the lease

5)

- a) Rent expense on operating leases in the fiscal year 2009 was \$41,714.
- b) Rent expense appeared on the Balance Sheet as 'deferred rent.'

6)

- a) $CF_1 = 50,561$; $CF_2 = 47,107$; $CF_3 = 42,345$; $CF_4 = 35,469$; $CF_5 = 31,319$;
 $CF = 25,228$ $F = 3$; $I = 7\%$ → $NPV = 219,643$

b) **Journal Entry:**

Lease Equipment	\$	219,643
Lease Liability		219,643
Interest Expense		62,934
Interest Payable		62,934

To record the leased equipment

c) The company would have reported 219,643 as the cost of Property and equipment, net under total assets at January 2, 2010.

d) The company would have reported 219,643 as the cost of Long term obligations under capital leases under total current liabilities and 62,934 as total liabilities at January 2,2010.

e) **Journal Entry:**

Interest Expense	\$	15,375
Interest Payable		15,375

To record interest expense

Depreciation Expense	\$	35,322
Accumulated Depreciation		35,322

To record depreciation expense

7) Management has incentives to structure the company's leases as operating for two reasons:

- First, unlike the capital lease (the entire lease amount except the interest payable is shown as a liability), the lessee in the operating lease gets to expense the lease payments under the income statement
- Second, the capital lease will produce lower ROE and ROA ratios.

Under the operating lease the effects on the financial statements include:

- Net income will reduce
- Both current and long-term liabilities will reduce
- No assets will be recorded

8) If they had capitalized their leases then the liquidity and solvency ratios would be affected (operating lease ratios are in the parentheses).

Current Ratio:	1.00 (1.66)
Debt-to-Equity Ratio:	1.56 (0.22)
Long-term Debt to Assets Ratio:	0.51 (0.13)

So, the answer is no, the decision to capitalize leases will not always yield a weaker liquidity and solvency ratios. As seen in the debt-to-equity ratio and in the long-term debt to asset ratio that the ratios for the capital lease is greater than the ratios for the