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Application of Accounting Principles in a Collection of Case Studies

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APPLICATION OF ACCOUNTING PRINCIPLES IN A COLLECTION OF CASE STUDIES

by
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Approved by

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I would like to dedicate this thesis to my parents, Olga and Azret Kalmykov.
Thank you for your endless love and support!

I would also like to thank my thesis advisor, Dr. Victoria Lynn Dickinson for being a mentor to me during my college years.

ABSTRACT

TAMARA KALMYKOVA: Application of Accounting Principles in a Collection of Case Studies

(Under the direction of Dr. Victoria Dickinson)

This thesis is a compilation of case studies that I have conducted within the period of 6 months. Each case study is independent from one another. The main purpose of these case studies is to investigate complex accounting issues that are very common in real practice.

In each case I did my best to understand accounting principles that are applied in a specific situation and further investigate the issue. In order to identify the problematic areas, I analyzed the facts that were given to me and then implemented solutions based on my accounting knowledge and extensive research I have conducted.

The whole thesis writing process taught me to be more analytical. It also gave me a new set of skills that I used during my internship that I have done after the completion of my thesis.

There is far more to accounting that it may seem like, it is more than just numbers and calculations. Accounting is a whole new world of principles and rules that one should be able to apply and understand, in order to be able to call oneself an accountant.

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Case Study 1

Home Heaters Incorporated

i. Executive Summary

Two companies, Glenwood Heater, Inc. and Eads Heater, Inc. that have been under analysis both started functioning in 20X1. In the first period after opening, the companies had identical transaction in Glenwood Heating, Inc. and Eads Heating.

However, under the circumstances of being in different environments, both companies started making their own different accounting decisions.

ii. Analyzing these companies, it was established that Glenwood Heater, Inc. would make the better investment choice. Spreadsheets for Glenwood Heater, Inc. and Eads Heater, Inc. record the difference in the transactions of the companies. Eads Heater, Inc. records Bad Debt Expense as of $4,970, whereas Glenwood Heater, Inc. records only $994, even though record of sales of $398,5000 was made in both companies' spreadsheets. Cost of Goods Sold $188,800 is higher in Eads Heater, Inc. than in Glenwood Heater, Inc. where Cost of Goods Sold is equal to $177,000. According to calculations, the difference in Depreciation Expense is significant as well, Eads Heater, Inc. recorded $41,500 of Depreciation Expense, and Glenwood Heater recorded $19,000, which, therefore, gives us discrepancy of $22,500. Another contradiction came up in how to record leased equipment. Glenwood Heater records it as an asset, yet Eads Heater records leased equipment as a liability.

Assets

Cash	Accounts Receivable	Allowance for Bad Debts	Inventory	Land	Building	Acc. Dep., Bldg	Equipment	Acc. Dep., Equipment	Leased Equipment	Acc. Dep., Leased Equipment
$ 160,000										
$ 400,000										
$ (420,000)				$ 70,000	$ 350,000					
$ (80,000)							$ 80,000			
			$ 239,800							
	$ 398,500									
$ 299,100	$ (299,100)									
$ (213,360)										
$ (41,000)										
$ (34,200)										
$ (23,200)										
		$ 994								
			$ (177,000)							
						$ 10,000		$ 9,000		
$ (16,000)										
$ (30,914)										
$ 426	**$ 99,400**	**$ 994**	**$ 62,800**	**$ 70,000**	**$ 350,000**	**$ 10,000**	**$ 80,000**	**$ 9,000**	**$ -**	**$ -**

Liabilities

Accounts Payable	Interest Payable	Note Payable	Lease Payable
		$ 400,000	
$ 239,800			
$ (213,360)			
		$ (20,000)	
	$ 6,650		
$ 26,440	**$ 6,650**	**$ 380,000**	**$ -**

Equity

Common Stock	Retained Earnings	Dividends	Sales	Cost of Goods Sold	Bad Debt Expense	Depr. Exp.	Interest Expense	Other Oper. Expense	Rent Expense	Prov. Income Taxes
$ 160,000										
			$ 398,500							
							$ 21,000			
								$ 34,200		
		$ 23,200								
							$ 6,650			
					$ 994					
				$ 177,000						
						$ 19,000				
									$ 16,000	
										$ 30,914
$ 160,000	**$ -**	**$ 23,200**	**$ 398,500**	**$ 177,000**	**$ 994**	**$ 19,000**	**$ 27,650**	**$ 34,200**	**$ 16,000**	**$ 30,914**

<u>Glenwood Heater, Inc.</u>

<u>Trial Balance for Part A & B</u>

Account		Dr.	Cr.
Cash		$ 7,835	
Accounts Receievable		$ 99,400	
Allowance for Bad Debts			$ 4,970
Inventory		$ 51,000	
Land		$ 70,000	
Building		$ 350,000	
Accumulated Depreciation, Building			$ 10,000
Equipment		$ 80,000	
Accumulated Depreciation, Equipment			$ 20,000
Leased Equipment		$ 92,000	
Accumulated Decpreciation, Leased Equipment			$ 11,500
Liability Accounts			
Accounts Payable			$ 26,440
Interst Payable			$ 6,650
Note Payable			$ 380,000
Lease Payable			$ 83,360
Equity Accounts			
Common Stock			$ 160,000
Retained Earnings			
Dividends		$ 23,200	
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	
Rent Expense			
Provision for Income Taxes		$ 23,505	
TOTALS:		$ 1,101,420	$ 1,101,420

Assets

Cash	Accounts Receivable	Allowance for Bad Debts	Inventory	Land	Building	Acc. Dep., building	Equipment	Acc. Dep., equipment	Leased Equipment	Acc. Dep., Leased Equipment
$ 160,000										
$ 400,000										
$ (420,000)				$ 70,000	$ 350,000					
$ (80,000)							$ 80,000			
			$ 239,800							
	$ 398,500									
$ 299,100	$ (299,100)									
$ (213,360)										
$ (41,000)										
$ (34,200)										
$ (23,200)										
		$ 4,970								
			$ (188,800)							
						$ 10,000		$ 20,000		
$ (16,000)									$ 92,000	$ 11,500
$ (23,505)										
$ 7,835	$ 99,400	$ 4,970	$ 51,000	$ 70,000	$ 350,000	$ 10,000	$ 80,000	$ 20,000	$ 92,000	$ 11,500

Liabilities

Equity

Accounts Payable	Interest Payable	Note Payable	Lease Payable	Sales	Cost of Goods Sold	Bad Debt Exp.	Dep. Exp.	Int. Exp.	Other Oper. Exp.	Rent Exp.
		$ 400,000								
$ 239,800										
				$ 398,500						
$ (213,360)										
		$ (20,000)						$ 21,000		
									$ 34,200	
	$ 6,650							$ 6,650		
						$ 4,970				
					$ 188,800					
							$ 30,000			
			$ 83,360				$ 11,500	$ 7,360		
$ 26,440	$ 6,650	$ 380,000	$ 83,360	$ 398,500	$ 188,800	$ 4,970	$ 41,500	$ 35,010	$ 34,200	$ -

Prov. Income Taxes	Retained Earnings	Dividends	Sales	Common Stock
				$ 160,000
			$ 398,500	
		$ 23,200		
$ 23,505				
$ 23,505	$ -	$ 23,200	$ 398,500	$ 160,000

Eads Heater, Inc. Trial Balance for

Part A & B

	Dr.	Cr.
Cash	$ 7,835	
Accounts Receievable	$ 99,400	
Allowance for Bad Debts		$ 4,970
Inventory	$ 51,000	
Land	$ 70,000	
Building	$ 350,000	
Accumulated Depreciation, Building		$ 10,000
Equipment	$ 80,000	
Accumulated Depreciation, Equipment		$ 20,000
Leased Equipment	$ 92,000	
Accumulated Decpreciation, Leased Equipment		$ 11,500
Liability Accounts		
Accounts Payable		$ 26,440
Interst Payable		$ 6,650
Note Payable		$ 380,000
Lease Payable		$ 83,360
Equity Accounts		
Common Stock		$ 160,000
Retained Earnings		
Dividends	$ 23,200	
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	
Rent Expense		
Provision for Income Taxes	$ 23,505	
TOTALS:	$ 1,101,420	$ 1,101,420

iii. Balance Sheet is very important for investors, because it reflects how much assets is owned and what the financial obligations are. It is better to invest in a company with a lower amount of expenses, because in this case the revenues are more likely to be higher. Discrepancy affected all the future statements. All the statements are included in the following pages.

One of the signs of a strong balance sheet is cash and short-term investments; it does not provide payments for the current liabilities. However, it can provide the returns for shareholders, like purchasing stocks and paying off the dividends. Any company, no matter how profitable it is, makes purchases on credit. In this case, Eads Heater, Inc. holds more cash than Glenwood Heater, Inc. However, looking at Balance Sheets of both companies, we can see that Eads Heater, Inc. has $83,360 more in long-term liabilities than Glenwood.

Glenwood Heating Inc.
Balance Sheet
FYE 20X1

5

	Dr.	*Cr.*
Assets		
Current Assets:		
Cash	426	
A/R	99,400	
Allow for B/D		-994
Inventory	62,800	
Non-Current Assets		
Building	350,000	
Land	70,000	
Equipment	80,000	
Less: Accum Depr, Equip		-9,000
Less: Accum Depr, Bldg		-10,000
Total Assets	642,632	
Liabilities		
Current Liabilities		
A/P		26,440
Interest Pay		6,650
Long-Term Liabilities		
Notes Pay		380,000
Equity		
Common Stock		160,000
Dividends	23,200	
Sales		398,500
CGS	177,000	
Bad Debt Expense	994	
Depr. Expense	19,000	
Interest Expense	27,650	
Other Operating Expense	34,200	
Rent Expense	16,000	
Income Tax	30,914	
	328,958	971,590
Total Liab.+ Equity		642,632

Eads Co.
Balance Sheet
FYE 20X1

	Dr.	*Cr.*
Assets		
<u>*Current Assets:*</u>		
Cash	7,835	
A/R	99,400	
Allow for B/D		-4,970
Inventory	51,000	
<u>*Non-Current Assets*</u>		
Builiding	350,000	
Land	70,000	
Equipment	80,000	
Leased Equipment	92,000	
Less: Accum Depr, Bldg		-10,000
Less: Accum Depr, Equip		-20,000
Less: Accum Depr, Leased Equip		-11,500
<u>***Total Assets***</u>	703,765	
Liabilities		
A/P		26,440
Int Pay		6,650
Notes Pay		380,000
Lease Pay		83,360
Equity		
Common Stock		160,000
Dividends	23,200	
Sales		398,500
CGS	188,800	
Bad Debt Exp	4,970	
Depr. Exp	41,500	
Int. Exp	35,010	
Other Operating Income Exp.	34,200	
Income Tax	23,505	
	351,185	1,054,950
Total Liab.+ Equity		703,765

iv. Another way to check profitability would be to do Current Ratio. The higher the ratio, the bigger the chance that the company will be able to pay its current liabilities

Current Ratio= Current Assets/ Current Liabilities

Eads Heater, Inc.: $153,265/$33,090= 4.63

Glenwood Heater, Inc.: $162,626/$33,090= 4.91

As can be seen, Glenwood Heater, Inc. Current Ratio is higher than Eads Heater, Inc., so that means that Glenwood can fulfill their obligations faster than Eads.

v. Next reason why investing in Glenwood Heater, Inc. would be smarter than investing in Eads Heater, Inc. can be explained by looking at the Income Statements of two companies. Even though the amount of sales was recorded identically, the differences in the ways of recording transactions led to the differences in Net Income (See *table_ 7,8, Eads Income Stmt and Glenwood Income Stmt). Eads Heater, Inc. has a lower net income, which is expected. Net Income shows the amount of money that firms hold after all the expenses, dividends, interests, and taxes are paid. "Bottom line," or Net Income, attracts investors and makes a company desired.

Glenwood Co. ***Income Statement*** ***FYE 20X1***		
Sales Revenue		398,500
CGS	177,000	
Gross Profit		221,500
Less: Expenses		
Oper. Expense	34200	
Depr. Bldg	10000	
Depr. Equip	9000	
Rent Expense	16000	
Int Exp	27650	
Bad Debt Exp	994	
Income Before Tax		123,656
Less: Tax	30914	
Net Income		92,742

<u>Eads Co.</u> ***<u>Income Statement</u>*** ***<u>FYE 20X1</u>***		
Sales Revenue		398500
CGS	188800	
Gross Profit		209700
Less: Expense		
Bad Debt Exp	4970	
Depr Exp	41500	
Int Exp	35010	
Operating exp	34200	
Net Income before Tax		94020
Less: Tax	23505	
Net Income		70,515

vi. Next statements under analysis are Statements of Changes in Equity (See *table_9 attached). Such statements provide help in identifying the changes in the owners' equity. A statement of changes in the owners' equity provides the information about it, which is not disclosed in any other statement. After examining the two companies, Glenwood Heater, Inc. and Eads Heater, Inc., Glenwood has a higher total stockholder's equity than Eads. Therefore, the value of Glenwood Heater, Inc. is higher than the value of Eads Heater, Inc.

Glenwood Co.			
Statements of Changes in Equity			
FYE 20X1			
	Share Capital	**R/E**	**Total Equity**
Bal 1/1/X1	$ 160,000	$ -	$ 160,000
Change in equity for Year 1			
Issue of Common Stock			
Add: Income		$ 92,742	
Less: Dividends		$ 23,200	
Bal 1/31/X1	**$ 160,000**	**$ 69,542**	**$ 229,542**

Eads Co.			
Stmt of Changes in Equity			
FYE 20X1			
	Share Capital	**R/E**	**Total Equity**
Balance 1/1/X1	$ 160,000	$ -	$ 160,000
Changes in Equity for year X1			
Issue of Common Stock			
Add: Income		$ 70,515	
Less: Dividends		$ 23,200	
Bal 1/31/X1	**$ 160,000**	**$ 47,315**	**$ 207,315**

vii. The Statement of Cash Flow provides an investor with information of how much cash is coming in and out. There are three different ways of cash flow: from operations, from investing, from financing. Cash flow from investing shows how much and on what a company spends its cash.

Glenwood Heating, Inc.

Statement of Cash Flows

For 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		
Income Statement items not affecting cash		
Depreciation Expense	$19,000	
Changes in Current Assets and Current Receivables		
Increase in Accounts Receivable	($99,400)	
Increase in Inventory	($62,800)	
Increase in Allowance for Bad Debts	$994	
Increase in Accounts Payable	$26,440	
Increase in Interest Payable	$6,650	
Net Cash Used by Operating Activities		($16,374)
Cash Flows from Investing Activities		
Cash paid for purchase of equipment	($80,000)	
Cash paid for land	($70,000)	
Cash paid for building	($350,000)	
Net Cash Used by Investing Activities		($500,000)
Cash Flows from Financing Activities		
Cash received from issuing stock	$160,000	
Cash paid for dividends	($23,200)	
Cash received from note payable	$400,000	
Cash paid for principal of note payable	($20,000)	
Net Cash Provided by Financing Activities		$516,800
Net Increase in Cash		$426
Cash balance at prior year-end		$0
Cash balance at current year-end		$426

Eads Heaters, Inc.

Statement of Cash Flows

For 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		
Income Statement items not affecting cash		
Depreciation Expense	$41,500	
Changes in Current Assets and Current Receivables		
Increase in Accounts Receivable	($99,400)	
Increase in Inventory	($51,000)	
Increase in Allowance for Bad Debts	$4,970	
Increase in Accounts Payable	$26,440	
Increase in Interest Payable	$6,650	
Net Cash Used by Operating Activities		($325)
Cash Flows from Investing Activities		
Cash paid for purchase of equipment	($80,000)	
Cash paid for purchase of land	($70,000)	
Cash paid for purchase of building	(350,000)	
Net Cash Used by Investing Activities		($500,000)
Cash Flows from Financing Activities		
Cash received from issuing stock	$160,000	
Cash paid for dividends	($23,200)	
Cash paid for principal of lease agreement	(8,640)	
Cash received from note payable	$400,000	
Cash paid for principal of note payable	($20,000)	
Net Cash Provided in Financing Activities		$508,160
Net Increase in Cash		$7,835
Cash balance at prior year-end		$0
Cash balance at current year-end		$7,835

Cash flow from operations and financing shows how cash comes in. In highly automated companies the net cash used by operations might be negative, which can be seen on both companies' statements of cash flows.

Investing activities generate outflows of cash, for example, capital expenditures such as land, equipment and building, etc. Three of these expenditures can be observed on the statements of cash flows of our companies. Assets like these support the company's competitive advantage and efficiency.

Financing activities mostly consist of debts and equity. Investors also should take a closer look at the dividends paid, because dividends are paid with cash and not profits.

Timing of cash flows is very important for cash analysis. Statement of Cash Flows includes both current and past periods that have made influence on cash flow.

Observing statements of cash flows of both companies, it is clear that Glenwood is doing well because it does not store excess cash that can be used for investing activities.

viii. Because of the information that the statements provided, Glenwood Heater, Inc. is the best choice for investing. After analyzing the statements of these two companies, the best investment opportunity would be Glenwood Heater because of the reasons disclosed earlier: net income, cash flow, and current ratio.

Case Study 2

Totz and Doodlez

Totz, an SEC registrant, manufactures and sells high-quality and stylish children's clothing. The products are sold through the stores. Each store includes Doodlez, an in-store art studio, which offers painting, pottery, and drawing classes.

The goal of this case study is to determine the appropriate income statement presentation for some specific items and to provide the appropriate authoritative guidance to support a recommendation.

1. First item under analysis is Net Sales. In fiscal 2015 Totz's Net Sales concluded $74.5 million, $3.9 million of revenues were from Doodlez.
In fiscal year 2016 Totz's Net Sales were $86.5 million and $11.2 million of which were revenues from Doodlez. The remaining increase in total net sales of $4,7 million was because of an increase in the average transaction value.

According to FASB, ASC 225-10-S99-2 (b) states:
If income is derived from more than one of the subcaptions described under §210.5–03.1, each class which is not more than 10 percent of the sum of the items may be combined with another class. If these items are combined, related costs and expenses as described under § 210.5–03.2 shall be combined in the same manner.

1. Net sales and gross revenues. State separately:

(a) Net sales of tangible products (gross sales less discounts, returns and allowances),

(b) Operating revenues of public utilities or others;

(c) Income from rentals;

(d) Revenues from services; and

(e) Other revenues.

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

Doodlez and Totz both have revenues of over 10 percent; therefore, they should be stated separately on the income statement. Because Doodlez provides services its revenue should be placed under service revenue. Similarly, because Totz sells tangible products its revenue should be placed under product revenue.

2. Next item under analysis is Gross Profit; Totz has a gross profit of $28 million in fiscal 2015, and $30.4 million in fiscal 2016, an increase of $2.4 million, or 8.6 percent. Cost of sales includes expenses incurred to acquire and produce inventory for sale, excluding depreciation. Cost of sales increased from $46.5 million in fiscal 2015 to $56.1 million in 2016; an increase of $9.6 million, or 20.6 percent, as the result of an increase in the cost of Doodlez' services.

SAB Topic 11. B, ASC 225-10-S99-8, Depreciation and Depletion Excluded from Cost of Sales states:

If cost of sales or operating expenses exclude charges for depreciation, depletion and amortization of property, plant and equipment, the description of the line item should read somewhat as follows: "Cost of goods sold (exclusive of items shown separately below)" or "Cost of goods sold (exclusive of depreciation shown separately below)." To avoid placing undue emphasis on "cash flow," depreciation, depletion and amortization should not be positioned in the income statement in a manner, which results in reporting a figure for income before depreciation.

Therefore, if Totz reported gross profit excluding depreciation, it would be violating ASC 225-10-S99-8 about not reporting a subtotal that excludes depreciation. As such, Totz should not report a gross profit subtotal because the excluded depreciation is attributable to cost of sales.

Additional information on this particular topic can be provided by ASC 270-10-45-4:

Costs and expenses for interim reporting purposes may be classified as either of the following:

a. Costs associated with revenue - those costs that are associated directly with or allocated to the products sold or to the services rendered and that are charged against income in those interim periods in which the related revenue is recognized
b. All other costs and expenses - those costs and expenses that are not allocated to the products sold or to the services rendered and that are charged against income in interim fiscal periods as incurred, or are allocated among interim periods based

on an estimate of time expired, benefit received, or other activity associated with the periods.

Therefore, product costs, freight-in and import costs, and direct labor costs should be reported under cost of goods sold, as they are associated with revenue.

3. Totz relocated its corporate headquarters to Mountain View, CA. In connection with the relocation, Totz sold the abandoned building and realized a gain of $1.7 million on the sale.

Reg S-X, Rule 5-03(b)(6) states that you should include items not normally included in SG&A in this category. Further, ASC-605-10-S99-1 states, "Gains or losses from the sale of assets should be reported as 'other general expenses' Any material item should be stated separately." Finally, ASC-360-10-45-5 states, "A gain or loss recognized on the sale of the 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." Taken together, the gain on the sale of the corporate headquarters should be presented as operating income.

According to ASC 225-20-45-2:

a. Unusual nature. The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates.
b. Infrequency of occurrence. The underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates.

FASB ASC 225-10-s99-2 states: “State separately in the income statement or in a note thereto amounts earned from miscellaneous other income.”

The gain of $1.7 million should be reported under non-operating income on the income statement.

4. Totz became aware that the natural fiber materials provided by one of its fabric suppliers were not, in fact, natural. During fiscal 2016, Totz settled a class action lawsuit related to the legal case against the supplier in connection with this scandal and received proceeds of $2.7 million.

According to the facts presented, the costs associated with the natural fiber materials provided by the supplier are part of Totz’ central operations; therefore, the gain recognized in connection with the class action settlement should be presented within operating income. Any material item should be stated separately. 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 (i.e., not just expenses or losses).

Case Study 3

Financial Statement of Rocky Chocolate Mountain Factory

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

Rocky Mountain Chocolate Factory Trial Balance and Transactions

	Beginning balace (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. Incurs SG&A (cash and payable)	7. Pay Wages	8. Receive franchise fee	9. Purchase PPE	10. Dividends declared and paid	11. All other transactions	Unadjusted Trial Balance	12. Adjust for Inventory	13. Record depreciation	14. Wages accrual	15. Consultant's report	Pre-closing Trial balance	16. Closing entry	Post-closing (ending) balance
Cash and cash equivalents	1,253,947			17,000,000	-8,200,000	4,100,000	-2,000,000	-6,423,789	125,000	-498,832	-2,403,458	790,224	3,743,092					3,743,092		3,743,092
Accounts Receivable	4,229,733			5,000,000		-4,100,000						-702,207	4,427,526					4,427,526		4,427,526
Notes Receivable, current	0											91,059	91,059					91,059		91,059
Inventories	4,064,611	13,500,000		-14,000,000								-66,328	3,498,283	-216,836				3,281,447		3,281,447
Deferred Income Taxes	369,197											92,052	461,249					461,249		461,249
Other	224,378											-4,215	220,163					220,163		220,163
Property and Equipment, Net	5,253,598									498,832		132,859	5,885,289		-698,580			5,186,709		5,186,709
Notes Receivable, less curent portion	124,452											139,198	263,650					263,650		263,650
Goodwill, net	1,046,944												1,046,944					1,046,944		1,046,944
Intangible assets, net	183,135											-73,110	110,025					110,025		110,025
Other	91,057											-3,007	88,050					88,050		88,050
Accounts Payble	1,074,643	7,500,000			-8,200,000							503,189	877,832					877,832		877,832
Accrued salaries and wages	423,789		6,000,000					-6,423,789.000					0			646,156		646,156		646,156
Other accrued expenses	531,941						3,300,000					-2,885,413	946,528					946,528		946,528
Dividend payable	598,986										3,709	-1	602,694					602,694		602,694
Deferred Income	142,000								125,000			-46,062	220,938					220,938		220,938
Deferred Income Taxes	827,700											66,729	894,429					894,429		894,429
Common Stock	179,696											1,112	180,808					180,808		180,808
Additional Paid-in Capital	7,311,280											315,322	7,626,602					7,626,602		7,626,602
Retained Earnings	5,751,017										-2,407,167		3,343,850					3,343,850	3,580,077	6,923,927
Sales	0			22,000,000								944,017	22,944,017					22,944,017	-22,944,017	0
Franchise and royalty fees	0											5,492,531	5,492,531					5,492,531	-5,492,531	0
Cost of sales	0			14,000,000								693,786	14,693,786	216,836				14,910,622	-14,910,622	0
Franchise costs	0											1,499,477	1,499,477					1,499,477	-1,499,477	0
Sales & Marketing	0						1,505,431.00						1,505,431					1,505,431	-1,505,431	0
General and Administrative	0						2,044,569.00					-261,622	1,782,947			639,200		2,422,147	-2,422,147	0
Retail Operating	0						1,750,000						1,750,000			6,956		1,756,956	-1,756,956	0
Depreciation and amortization	0												0		698,580			698,580	-698,580	0
Interest income	0											-27,210	-27,210					-27,210	27,210	0
Income Tax Expense	0											2,090,468	2,090,468					2,090,468	-2,090,468	0

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

3

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

Assets		
Current Assets		
Cash and cash equivalents	$	3,743,092
Accounts Receivable	$	4,427,526
Notes Receivable, current	$	91,059
Inventories	$	3,281,447
Deferred Income Taxes	$	461,249
Other	$	220,163
Total current assets	**$**	**12,224,536**
Property and Equipment, Net	**$**	**5,186,709**
Other assets		
Notes Receivable, less curent portion	$	263,650
Goodwill, net	$	1,046,944
Intangible assets, net	$	110,025
Other	$	88,050
Total other assets	**$**	**1,508,669**
Total assets	**$**	**18,919,914**
Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts Payble	$	877,832
Accrued salaries and wages	$	646,156
Other accrued expenses	$	946,528
Dividend payable	$	602,694
Deferred Income	$	220,938
Total Current Liabilities	**$**	**3,294,148**
Deferred Income Taxes	**$**	**894,429**
Commitments and Contingencies		
Stockholders' Equity		
Preferred stock $0.1 par value; 250,000 autorized; 0 shares outstanding		
Senior A Junior Participating Preferred Stock, autorizes 50,000 shares		
Undesignated series, authorized 200,000 shares		
Common Stock, $0.3 par value; 100,000,000 shares authorized; 6,026,938 and 5,989,858 shares issued and outstanding respectively	$	180,808
Additional Paid-in Capital	$	7,626,602
Retained Earnings	$	6,923,927
Total Stockholders' equity	**$**	**14,731,337**
Total Liabilities and Stockholders'	**$**	**18,919,914**

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

3

Case Study 4

Fraudulent Activities and Implementation of Internal Controls

Fraud Scheme	Internal Control
Lack of a time clock enables employees to lie about the time they have worked.	Technology Update: An online program/software should be implemented to record time and hours worked (suggestion: Paycom.com).
An employee accepts a check for merchandise and completely bypasses the electronic system.	Physical Audit: A physical count of inventory should be done periodically to make sure sales and ending inventory match total inventory.
Since there is not a physical inventory count and all employees have authority to enter all types of transactions, an employee can make a sale and then create a false return right after and pocket the cash from the sale.	Separation of Duties: There should be only one employee authorized to make returns during the shift. Approval Authority: All employees are able to make returns but must first have approval from a manager to create this transaction.

	Physical Audits: A physical count of inventory and cash should be taken. Cash should be done on a daily basis; depending on size of the store, inventory counts can be done less frequently—monthly or quarterly.
During a transaction a discount is added to the full price for customer to pay. The system shows entire price recorded, but the employee pockets difference between full price and full price plus the discount that the customer pays.	Physical Audit: There should be a physical count of cash at the end of an employee's shift. Cash sales and credit sales should equal the amount of cash and total for credit card transactions, respectively.
Lack of security measures make it easy for employees to steal merchandise.	Physical safeguards: Cameras, locks, and sensors can be used to ensure that all merchandise taken outside of the store is paid for. Additionally, it adds to the safety of employees and merchandise in the case of a robbery.

The business is running on a simple accounting software.	Technology update: Using a more advanced accounting system can more accurately pinpoint and track discrepancies. In light of expansion, a more advanced system in necessary.
Lucy handles minor customer complaints. She could fake a complaint asking for a refund and then pocket the money for the refund.	Separation of Duties: There should be more than one person handling complaints and customer service. A suggested pipeline is delegating complaints and customer service to an experienced employee. This employee will forward the issue along with a solution to the manager who either approves or declines the suggestion. Upon approval, the store owner will send an email to the customer inquiring if the customer service was handled correctly and satisfying.

Employees can disguise fraud by using another employee's access code to the register.	Access Controls: Each employee's code to the register should be changed periodically to ensure they are kept unique and secret. Separation of Duties: Authorize only two employees to create transactions during the shift, and designate them to a specific register. This places the responsibility of each register reconciling on one employee.
Lucy has access to the accounting system and thus the inventory system; she can alter the inventory to cover up discrepancies in sales and the electronic inventory count.	Access Controls: Passwords should be implemented to access different parts of the accounting system. Not only does it keep unauthorized users out of the system but makes it easier to identify the source of error or discrepancy.
Employees are authorized to enter all types of transactions.	Approval Authority: Transactions of a large dollar amount or transactions that require a large amount of cash change being given back to the customer should be required to have manager approval before occurring.

Lucy summarizes and records daily sales in the accounting system and prepares bank deposits.	Separation of Duties: The job of reporting and depositing should be separated to lessen the chance of fraud.

Case Study 5

Inventory Assessment

1. Raw materials: The costs that are expected to be involved in Raw Materials Inventory are the historical costs of the inventory at the moment of purchase and transactions cost. Work in Process Inventory includes such costs as labor costs, material costs and overhead costs during the manufacturing process. Finished Goods Inventory consists of the costs from Work In Process including the costs of storing finished goods.

2. The inventories that include material, labor and manufacturing overhead costs are recorded net of an estimated allowance for obsolete or unmarketable inventory.

3.

a. The account Allowance for Obsolete or Unmarketable Inventory is a contra account against the inventory balance. It is not reported specifically on a Balance Sheet. The inventory balance already takes under consideration the balance of Allowance.

b. The gross amount of inventory for 2012 is: \$211,734 + \$10,800= **\$243,870**

The gross amount of inventory for 2011 is: \$233,070+ \$12,520=**\$224,254**

c. The amount of obsolete inventory is attributed to each of the three types of inventory:

<u>2012</u>

1. Raw Materials: ($43,469/$211,734) x $12,520= $2,570.37
2. Work-in-Process: ($619/$211,734) x $12,520= $36.60
3. Finished Goods: ($167,646/$211,734) x $12,520=$9,913.04

<u>2011</u>

1. Raw Materials: ($46,976/$233,070) x $10,800= $2,176.77
2. Work-in-Process: ($1,286/$233,070) x $10,800= $59.59
3. Finished Goods: ($184,808/ $233,070) x $10,800= $8,563.63

4.

Cost of Sales	13,348	
Allowance for Obsolete Inventory		13,348
Allowance for Obsolete Inventory	11,628	
Cost of Sales		11,628

Raw Materials

46,976	442,068
438,561	
43,469	

Accounts Pay

	39,012
	438,561
432,197	
	45,376

Work in Process

1286	568,735
126,000	
442,068	
619	

Finished Goods, Net

184,808	13,348
568,735	584,177
11,628	
167,646	

Cost of Sales

0	
584,177	
13,348	11,628
585,897	

a. Cost of Finished Goods Sold equals **$584,177**

b. Cost of Finished Goods transferred from work-in-process in the current year is **$568,735**

c. Cost of Raw Materials transferred from Work-in-Process in the current year is **$442,068**

d. Cost of Raw Materials purchased in the current year is **$438,561**

e. The amount of cash disbursed for raw material purchases during the current year equals **$ 432,197**

6. Inventory Turnover Ratio= Cost of sales/ Average inventories, net

2012: 585,897/(211,734+233,070)/2= 2.63

2011: 575,226/(233,070+268,591)/2=2.29

7. Inventory Holding Period= 365/Inventory Turnover Ratio

2011: 365/2.29= 159 days average to manufacture and sell inventory

2012: 365/2.63=139 days average to manufacture and sell inventory

Analyzing the numbers, the company is becoming more efficient in 2012 than in 2011.

8. Estimated amount of Obsolete Goods

2012: 13,348/167,646= 7.96%

(Allowance divided by finished goods inventory)

Looking from an investor's prospective, price/earnings ratio would be appropriate to take under consideration to judge whether the company is valued correctly.

Case Study 6

WorldCom Capitalized Costs and Earnings

a. i. Assets are economic resources that will bring future benefits to its owners as they are service potential and are involved in economic activities such as consumption, production, and exchange.. Within time some assets depreciate, or decrease in value worth, for example, cars, some assets will increase in value, for example, real estate property. Examples of assets are: Inventory, Prepaid Insurance, Property, Plant, Equipment (PPE), etc. There are many types of assets and every one of them brings out a special characteristic.

Expenses, however, are outflows of money. Expenses are incurred during the company's major operating periods. Examples of expenses are Supplies Expense, Advertising Expense, Delivery Expense, and many more.

ii. There are two ways of dealing with costs, and the question is whether to capitalize or expense the cost. Costs should be expensed when they don't have any measurable future value. Costs should be capitalized when they bring economic value in the future. For example, interest cost of constructing a building is capitalized during the construction period, which means interest cost is part of the cost of an asset, however, as soon as the constructing period is over any interest cost incurred is considered an expense.

b. As I mentioned earlier, costs after their initial capitalization become part of the cost of an asset.

Usually management of the firm decides whether to capitalize a cost, because effects of capitalizing costs has a great influence on financial statements such as balance sheet and income statement.

Capitalized cost will affect Net Income, because an entity, which chose to capitalize costs, will have a higher profitability in the early years, but as time passes by the profitability will become lower than if the company would have expensed the cost.

If a company capitalizes costs, assets reported on a balance sheet will be higher.

c. The company reported $14,739,000 as line costs for the year 2001.

The entry to record Line Expenses is:

Line Costs (Exp)	$14,739,000,000.00	
Cash		$14,739,000,000.00

Line costs on WorldCom's s statements were considered as assets, which in reality were fees that were paid to other providers who owned lines that WorldCom did not have access to, so they had to pay the fee for using them.

d. Line costs were the type of costs that were improperly capitalized. WorldCom converted these expenses into assets, when they absolutely do not belong to this group, because they do not have any future economic value, which proves that line costs should be expensed.

e. Journal Entry to undo incorrect capitalization of line costs.

PPE (asset)	$3,055,000,000.00	
Line Costs (Exp)		$3,055,000,000.00

Property Plant Equipment Cost appears in the asset section in PPE on the balance sheet, because they were capitalized. The statement of cash flows is wrong because depreciation is misstated also as well as it is overstating income.

f.

Minority Interest	Years	Quarter	Depreciation Expense
$771,000,000.00	22	1	$35,045,454.55
$610,000,000.00	22	3/4	$20,795,454.55
$743,000,000.00	22	1/2	$16,886,363.64
$931,000,000.00	22	1/4	$10,579,545.45
			$83,306,818.18

Journal Entry to record Depreciation Expense:

Depreciation Expense	83,306,818.18	
Accumulated Depreciation		83,306,818.18

g.

Income before taxes, as reported	$2,393,000,000.00
Add: Depreciation for the year from part (F)	$35,045,454.55
<Line Costs that were improperly capitalized>	($3,055,000,000.00)
<Loss Before taxes, restated>	($626,954,545.55)
<Income tax benefit>	($219,434,090.91)
<Minority Interest >	($1,187,539,204.00)
Net Loss, restated	($341,150,568.00)

Difference in Net Income reported by WorldCom and actual is significant, because actual is showing $341,150,568 million loss, which is quite significant even for the company like WorldCom.

Case Study 7

Targa Company: Employee Benefits

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

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

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

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

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

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

c. The line item(s) in the income statement or the statement of activities in which the costs in (b) are aggregated

d. For each reportable segment, as defined in Subtopic 280-10, the total amount of costs expected to be incurred in connection with the activity, the amount incurred in the period, and the cumulative amount incurred to date, net of any adjustments to the liability with an explanation of the reason(s) why

e. If a liability for a cost associated with the activity is not recognized because fair value cannot be reasonably estimated, that fact and the reasons why.

Accounting for One-Time Employee Termination Benefits is suggested in ASC 420-10-25-4:

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

a. Management, having the authority to approve the action, commits to a plan of termination.

b. The plan identifies the number of employees to be terminated, their job

c. The plan establishes the terms of the benefit arrangement, including the benefits that employees will receive upon termination (including but not limited to cash payments), in sufficient detail to enable employees to determine the type and amount of benefits they will receive if they are involuntarily terminated.

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

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

Relocation and training costs could be found in the Start-Up Costs Section ASC 720-15-55-6:

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

c. Training costs for employee

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

Case Study 8

Merck & Co., Inc. – Shareholders' Equity

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

The objectives of this case study are to analyze financial statements of Merck & Co. and to answer following questions. Financial statements disclosed are Consolidated Income Statement, Consolidated Statement of Retained Earnings, Consolidated Statement of Comprehensive Income, Consolidated Balance Sheet, Consolidated Statement of Cash Flows, and Notes.

a.

i. <u>How many common shares is Merck authorized to issue?</u>

Merck & Co. authorized to issue 5,400,000,000 common shares as it can be found on Consolidated Balance Sheet.

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

Merck&Co. issued 2,983,508,675 common shares.

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

To reconcile the number of shares issued, dollar value of common stock needs to be multiplied by number of shares issued at December 31, 2007:
1 cent * 2,983,508,675 shares=29.8 billion

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

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

v. <u>How many common shares are outstanding at December 31, 2007?</u>

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

vi. <u>At December 31, 2007, Merck's stock price closed at $57.61 per share. Calculate the total market capitalization of Merck on that day.</u>

Total market capitalization of Merck&Co.:

2,983,508,675 shares issued in 2007 * $57.61=171,879, 934,766.75

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

Companies pay dividends on their common or ordinary shares to prove that they are profitable and have enough earnings to provide dividends their investors. It also proves stability of a company and financial strength, when dividends are being paid regular. However, if the dividends are paid regular and suddenly something happens that a company cannot pay its stakeholders, there might be a chance of a market "freak-out", which can affect market's opinion about a company from positive to negative and make a company look less attractive. After the dividends are paid, stock price goes down because the market capital has been decreased by the amount paid to stockholder, and it all happens on the ex-dividend date.

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

[i] Companies would repurchase their own stock:

(a) the stock is undervalued

(b) to increase EPS

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

(d) to provide stock for employee stock compensation plans

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

(f) to provide a tax efficient distribution to shareholders

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

	Dr.	Cr.
RE	3310.7 billion	
Dividends Pay		3.4 million
Cash		3307.3 billion

g.

i. Merck & Co. uses Cost Method to account for its treasury stock transactions. Cost method is one of the methods to account for treasury stock. Under cost method the stock that are being bought back are recorded at the cost of purchase.

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

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

iv. Merck doesn't disclose treasury stock as an asset because treasury stock is not an asset; it is a contra equity account. Also a company cannot receive any economic benefit by dealing with its own stock.

i. Ratio Analysis

	2007	2006
Dividends paid	$3,307,300,000	$3,322,600,000
Shares outstanding	2,172,502,884	2,167,785,445
Net income	3,275,400,000	4,433,800,000
Total assets	48,350,700,000	44,569,800,000
Operating cash flows	6,999,200,000	6,765,200,000
Year-end stock price	$57.61	41.94
Dividends per share	$1.52	$1.53
Dividends yield (dividends per share to stock price)	2.6%	3.6%
Dividends payout (dividends to net income)	101%	74.9%
Dividends to total assets	6.8%	7.5%
Dividends to operating cash flows	47.3%	49.1%

Case Study 9

Xilinx, Inc.—Stock-Based Compensation

a. Xilinx decided to provide employees with stock options. Stock options are granted to make employees work harder. Having a stock option, employees have an incentive to boost company's performance since they would want to increase the market share, because if the stock's market price were higher than the call price, employee would be able to exercise the options or if it would be a convertible bond, they would be able to convert it into ordinary shares.

b. RSU or Restricted Stock Units are shares of Common Stock. Employee granted RSUs cannot receive stock immediately, and has to stick to a vesting plan. It is assigned a fair market value. When vesting moment comes, stock becomes non-forfeitable. Employee with stock options is able to buy shares at discount or stated rated, usually about in a year. However, there is a fear that the stock option might become worthless. Restricted Stock Units never become worthless, but it might take a while till the vesting period comes. In the early stages of a company stock options are usually better for both employees and the companies, because it can be exercised at a low price. RSU will be a subject for high tax, it can be advantageous for an employee, but not for a company in the early

RSUs would be more beneficial for an employee because of the limited risk linked to them, as well as no taxable income when the RSU are granted.

c. Grant Date is the date when employee is granted a stock option.

   Exercise price is a price per share at which owner of a traded option is entitled to sell or buy the security.

   Vesting period is a period an employee must wait until he is able to exercise his/her stock option or RSU.

   Expiration date is the date an employee no longer has the right to exercise the option.

   Options/ RSU granted – grant valued in terms of company's stock.

   Options exercised means purchasing stock at a grant price.

   Options / RSU forfeited or cancelled are the options that were never exercised.

d. Employee Stock Purchase Plan gives an opportunity to qualified employees to obtain a 24-month purchase right to purchase Company's common stock at the end of each six-month exercise period as stated in the notes. Employee Stock Purchase Plan is tax-efficient and lets employees purchase stock at a discount. Incentives for providing this option would be 85% of either the lower of the fair market value at the beginning of the 24-month offering period or the end of each six-month exercise period would not necessarily incentivize constant growth, because sabotage could lower the stock price, so employees could purchase it a steeper discount. However, it would encourage volatility because the employees would attempt to profit off of it anyway. However, if RSU are structured properly, they can be a better instrument to incentivize employees, for example, RSUs don't have a strike price, which means that as long as stock has value, RSUs will be valuable. Incentive for the firm to grant RSUs is that a company does not need to set a fair market value.

e. Xilinx distributes the costs based on employees departments and offsets with the expenses, scientists in R&D expense, design services in Cost of Revenues, and customer training in selling, general and administrative expense. The company measures the cost of all employee equity awards as compensation expense. Share-based payment requires cash flows resulting from excess tax benefits to be classified as a part of cash flows from financing activities.

f. i. Total expense before income taxes is $77,862 as Xilinx reported for stock-based compensation in 2013.

ii. Xilinx includes this expense in COGS, R&D Expense, Selling, General&Administrative expense.

iii. It increases of the net cash provided by operating activities. In 2013 expense is added back to the costs in the operating section of cash flow statement.

iv. Xilinx could not deduct tax immediately by law, so it created a tax liability. The tax expense will be recognized later when the employee gets compensated. Since the taxes will have already been paid, the expense will come out of a deferred tax asset account.

v. Dr. Cr.

COGS	6,356		
R&D Expense	37,937		
SG+A Expense	33,596		
		APIC-SO	77,862

i. As stated in the article stock options are going extinct, and the market is more welcoming to the restricted stock awards. Tax laws and regulations have affected these trends significantly. Sometimes stock options are more powerful than restricted stock, as the example given in the article: If a company's stock rises by about a third, an options grant can end up being worth double a restricted-stock grant of the same size. However, Restricted Stock Options are simpler and have fewer accounting and tax complexities. The preference in either Stock Options or RSUs depends on the situation; it is not easily determinable what is better for an employee unless all the possible expenses and benefits are calculated in a specific flow of events.

ii. Xilinx's statement does not prove the article's point of view that the stock options are on the verge of the extinction. Both RSUs and Stock Options were granted in recent years at Xilinx Company.

Case Study 10

Bier Haus – Revenue Recognition

Part 1

Background:

Week 1: a college student walks into the Bier Haus on campus and orders a large plastic cup of beer. The bartender takes the order and says it will cost $5. The student hands the bartender $5. The bartender then pours the beer into a large cup and hands it to the student.

1) How does each step in the five-step revenue model apply to this transaction?

As stated in ASC 606-10-05-04:

Step 1: Identify the contract(s) with a customer—A contract is an agreement between two or more parties that creates enforceable rights and obligations. The guidance in this Topic applies to each contract that has been agreed upon with a customer and meets specified criteria: The contract in this situation would be beer exchanged for money.

Step 2: Identify the performance obligations in the contract—A contract includes promises to transfer goods or services to a customer. If those goods or services are distinct, the promises are performance obligations and are accounted for separately. A good or service is distinct if the customer can benefit from the good or service on its own or together with other resources

that are readily available to the customer and the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract: Performance obligation is giving beer to a customer.

Step 3: Determine the transaction price—The transaction price is the amount of consideration in a contract to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. The transaction price can be a fixed amount of customer consideration, but it may sometimes include variable consideration or consideration in a form other than cash. The transaction price also is adjusted for the effects of the time value of money if the contract includes a significant financing component and for any consideration payable to the customer. If the consideration is variable, an entity estimates the amount of consideration to which it will be entitled in exchange for the promised goods or services. The estimated amount of variable consideration will be included in the transaction price only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved: $5

Step 4: Allocate the transaction price to the performance obligations in the contract—An entity typically allocates the transaction price to each performance obligation on the basis of the relative standalone selling prices

of each distinct good or service promised in the contract. If a standalone selling price is not observable, an entity estimates it. Sometimes, the transaction price includes a discount or a variable amount of consideration that relates entirely to a part of the contract. The requirements specify when an entity allocates the discount or variable consideration to one or more, but not all, performance obligations (or distinct goods or services) in the contract: $5 are allocated to a large plastic cup of beer.

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation—An entity recognizes revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service). The amount of revenue recognized is the amount allocated to the satisfied performance obligation. A performance obligation may be satisfied at a point in time (typically for promises to transfer goods to a customer) or over time (typically for promises to transfer services to a customer). For performance obligations satisfied over time, an entity recognizes revenue over time by selecting an appropriate method for measuring the entity's progress toward complete satisfaction of that performance obligation:

a performance obligation is fulfilled when Bier Haus hands beer to a customer.

B) To record this transaction:

Cash	$5		
		Sales Revenue	$5

Part 2

Week 2: the same student goes into the Bier Haus and orders a large beer in an Ole Miss thermal beer mug. The student plans to use this mug daily for refills rather than using plastic cups. The bartender pours the beer into the mug and delivers it to the student. The bartender then collects $7 from the student. Standalone selling prices are $5 for the beer and $3 for the mug, so the student got a bargain on the combined purchase. The student takes the beer in the new mug and enjoys it while reading the codification.

Step 1- Identify the contract: Exchange of beer and a mug in a bundle price of $7.

Step 2: Identify Performance obligations in the contract – giving beer and a cup instantaneously to a customer.

Step 3: Determine Transaction price: Transaction price is $ 7.

Step 4: Allocate the transaction price to the performance obligations: $7 are allocated to a bundle purchase, where $4.38 are allocated to Beer and $2.62 to the Mug by calculating relative sales price ($5/$8 x $7) and ($3/$8 x $7).

Step 5: Recognize revenue when the entity satisfies a performance obligation: a performance obligation is fulfilled when a bartender sells beer and a mug to a customer.

B. To record transaction of exchange of beer and a mug in a bundle price of $7.

Cash	$7	
	Sales Revenue - Beer	$4.38
	Sales revenue - Mug	$2.62

Part 3

Week 3: the same student goes into the

Bier Haus bringing in his beer mug and orders a large beer and a pretzel. Standalone selling prices are $5 for the beer and $2 for the pretzel. The bartender tells the student they are out of pretzels. The bartender then offers the student the large beer and a coupon for two pretzels (its typical business practice) for $7. The student pays $7 to the bartender. The bartender gives the student a coupon for two pretzels. The bartender pours the beer mug and hands it to the student. The student then takes the beer and the coupon and heads out. The Bier Haus sells a coupon for two pretzels for \$3.50. To increase visit, these coupons can be redeemed any date after the date of purchase. The Bier Haus has limited experience with these coupons but, so far, these coupons have always been redeemed.

To recognize the revenue the following steps need to be identified.

Step 1- Identify the contract:

- Exchange of beer and pretzels for money, however, there is an open contract for coupons on pretzels.

Step 2: Identify Performance obligations in the contract:

- Giving beer as soon as cash is received and obligations to redeem the coupon and provide a customer with two pretzels.

Step 3: Determine Transaction price:

- Transaction price is \$7.

Step 4: Allocate the transaction price to the performance obligations:

- The standalone price for the beer is \$4.11(\$5 x \$7/\$8.50) and standalone price of the coupon is (\$3.50x \$7/\$8.50).

Step 5: Recognize revenue when the entity satisfies a performance obligation:

- The obligation is satisfied as soon as the student gets the beer and the coupon, and bartender receives \$7.

b. To record this transaction:

Cash	\$7	
	Sales Revenue	\$7

Part 4

Week 4: The same student goes into the Bier Haus and orders two pretzels. The bartender takes the order and asks for a $4 payment. The student hands the bartender the coupon. The bartender reviews the coupon, determines its validity, and accepts it as payment. The bartender gives the student the two pretzels.

Step 1: Identify the contract:

- The student giving bartender a coupon for redeeming it for pretzels.

Step 2: Identify Performance obligations in the contract:

- Student will give the coupon to bartender and bartender will give him two pretzels.

Step 3: Determine Transaction price:

- $0

Step 4: Allocate the transaction price to the performance obligations:

- There is no allocation of transaction price.

Step 5: Recognize revenue when the entity satisfies a performance obligation:

- When a student redeems a coupon, Bier Haus should recognize the revenue earned.

b. To record this transaction:

Unearned revenue	$2.88	
	Sales revenue	$2.88

Case Study 11

ZAGG Inc.—Deferred Income Taxes

a. Book income, or pretax financial income is a financial reporting term. It also is often referred to as income before taxes, income for financial reporting purposes, or income for book purposes. Companies determine pretax financial income according to GAAP. (KIESO) Companies choose to report pretax financial income in order to disclose the information to their shareholders and investors.

The number in ZAGG's statement of operation for fiscal 2012 is $23,898.00, which is book income.

The difference between book income and taxable income is quite significant because book income is determined using GAAP, whereas taxable income is determined after consulting the IRS code. Also the difference would be that for financial reporting, companies use the full accrual method to report revenues, whereas for tax purposes, they used modified cash basis.

b. i. There are some differences between taxable income and pretax financial income that are permanent. Permanent tax differences result from items that (1) enter into pretax financial income but never into taxable income, (2) enter into taxable income but never into pretax financial income.

In the United States the examples of permanent differences would be accounting for meals and entertainment, municipal bond interest, penalties and fines, as well as purchase of life insurance for employees.

ii. Temporary tax difference is the difference between the tax basis of an asset or liability and its reported carrying amount in the financial statements, which will result in taxable amounts or deductible amounts in future years. However, they are called temporary because such differences eventually smooth out.

An example of temporary would be difference in depreciation method, for example, a company would use straight-line depreciation for book purposes, and for tax purposes it would use a more accelerated method.

iii. Statutory tax rate is the tax rate imposed by law; in this case it is 35%.

iv. Effective tax rate is the average rate of tax that a corporation actually pays. It is always be lower than statutory tax rate.

c. Deferred tax expense is the increase in the deferred tax liability balance from the beginning to the end of the accounting period. Big question that comes up is why a company reports deferred income taxes as part of their total income tax expense. Deferred income tax expense is deferred portion of income tax that is reported on the income statement. A company reports their deferred income taxes as part of their total income tax expense to make it more transparent and accurate.

d. Explain what deferred income tax assets and deferred income tax liabilities represent. Give an example of a situation that would give rise to each of these items on the balance sheet.

A deferred tax asset is the deferred tax consequence attributable to deductible temporary differences. If tax expense is smaller than current income tax liability it is a deferred tax asset.

If a company encounters loss, it usually uses that loss in order to lower taxes in the following years, so in that sense the loss would give a rise of a deferred tax asset. Deferred tax liability is the deferred tax consequence as a result of discrepancy in the book value and after-tax asset or liability. If tax expense were higher than current tax liability, the difference would be the deferred tax liability. Temporary difference causes future liabilities, so the company usually records a deferred tax liability, which will be the increase in future tax payable.

e. Explain what a deferred income tax valuation allowance is and when it should be recorded. A Company usually creates a valuation allowance for deferred tax asset if it can predict that they will not realize a portion of an asset. This amount is evaluated and updated in the end of each accounting in order to comply with tax laws. The tax effect of any valuation allowance used to offset the deferred tax asset can also impact the estimated annual effective rate. (Steven Bragg, Accounting Tools)

f. i. Using information in the first table in Note 8, show the journal entry that ZAGG recorded for the income tax provision in fiscal 2012?

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

ii. Using the information in the third table in Note 8, decompose the amount of "net deferred income taxes" recorded in income tax journal entry in part *f. i.* into its deferred income tax asset and deferred income tax liability components.

Income Tax Expense	9,393		
Deferred Tax Asset	8,002		
Deferred Tax Liab	291		
		Income Tax Pay	17,686

iii. The second table in Note 8 provides a reconciliation of income taxes computed using the federal statutory rate (35%) to income taxes computed using ZAGG's effective tax rate.

Calculate ZAGG’s 2012 effective tax rate using the information provided in their income statement. What accounts for the difference between the statutory rate and ZAGG’s effective tax rate?

ETR = Tax Expense / Pretax Income = 9,393 / 23,898 = 0.393 = 39.3%

Statutory rate x = 8,364

iv. According to the third table in Note 8 – Income Taxes, ZAGG had a net deferred income tax asset balance of $13,508,000 at December 31, 2012. This balance appears in Current DTT totaling $6,912, and in Noncurrent Deferred Income Tax and equals $6,596.

Case Study 12

Build-A-Bear Workshop - Leases

a. *Why do companies lease assets rather than buy them?*

Many companies do not like buying assets because they prefer to postpone using their capital and save it for a better cause. By leasing an asset companies can get immediate access to the assets, and pay it in monthly payments. The capital that is saved can be used for financial growth.

b. *What is an operating lease?*

Operating lease is a rental of an asset, but does not meet the classification of a capital lease. Operating leases have a shorter life. Lessee has unrestricted access to the assets during the rent period, but the quality and conditions of an asset need to be maintained upon the return of an asset to the lessor.

What is a capital lease?

Capital lease is a lease in which all the ownership rights are transferred to a lessee, and the assets are included into the lessee's balance sheet. Lessee records interest payment for the capital lease payment as an expense. The accounting for a capital lease is in the process of changing, however, the new rule is not in action till 2018. For now to account for capital leases the following steps need to be done:

- *Recognize capital lease*. If a lease meets several criteria needed to qualify for accounting as a capital lease, then record the present value of all lease payments as the cost of the fixed asset.

- *Record interest expense*. As the lessee makes lease payments to the lessor, record a portion of each payment as interest expense.
- *Capital lease depreciation*. The lessee calculates and records depreciation expense for the recognized amount of the asset. This can be a straight-line or some type of accelerated method of depreciation. The useful life for the depreciation calculation is typically the period over which lease payments are made.
- *Dispose of asset*. Once the lessee disposes of the asset at the end of its useful life, reverse the asset and accumulated depreciation accounts, and recognize any gain or loss on the disposal transaction.

What is a direct-financing lease?

A direct-financing lease is an arrangement where lessor buys assets and then leases them to the lessees, in order to generate income from interest payments

What is a sales-type lease?

Sales-type lease is a type of lease when the fair value of an asset is different from its carrying value, and there is a transfer of ownership rights in the end of the lease period. Usually sales-type leases consist of real estate.

c. Distinguishment between different types of leases is mandatory because it provides a user with fairer and relevant financial statements. As two main accountancy concepts are reliability and relevancy. Each type of the leases has different features and so a different way of accounting for it. If a company does not take under consideration the type of the lease, it would generate false information and misrepresentation, which would hurt financial world.

d.

i. Build-A-Bear Workshop's lease is treated as an operating lease.

ii. The journal entry to record the first lease payment:

	Dr.	Cr.
Rent Expense	100,000	
	Cash	100,000

iii. Entry to record first year of "first year rent-free":

	Dr.	Cr.
Lease Expense	100,000	
	Lease Payable	100,000

Record the entry for the years 2-5

	Dr.	Cr.
Rent Expense	125,000	
	Cash	125,000

e. i. Total amount of rent expense on operating leases for Build-A-Bear is $46.8 million.

ii. This number can be found in the company's operating expense section on the Income Statement in 2009.

f. i. Present value of the future minimum lease payments at January 2, 2010. Assuming 7% interest rate.

Year	PMTs	PV	PV pmt
1	50,651	0.93	47337.38
2	47107	0.87	41145.08
3	42345	0.82	34566.13
4	35469	0.76	27059.13
5	31319	0.71	22330.01
6	25229	0.67	16811.15
7	25229	0.62	15711.35
8	25229	0.58	14683.51
			219643.7483

ii. Journal entry a company to record the leases, leases considered as capital leases.

	Dr.	Cr.
Property and Equipment	219,643.75	
	Lease Obligation	219,643.75

Build-A-Bear Workshop would put the lease as an asset on their books and take full economic ownership of an asset.

v. Journal entries recorded in fiscal 2010 capital leases.

To record interest expense and lease payment:

	Dr.	Cr.
Lease Obligation	35,276	
Interest Expense	15,375*	
	Cash	50,651

*Carrying value of the lease obligations times your interest rate

219,644 * 0.07 = 15,375

To record amortization of leased asset considering useful life of an asset is 8 years:

	Dr.	Cr.
Depreciation Expense	27,455	
	Accum. Depreciation-PPE	27,455

*$219,644/8 years=$27,455

g. *What incentive does management have to structure its leases as operating leases?*

The biggest incentive for the company would be that under U.S. GAAP, Build-A-Bear Workshop would not need to report any depreciation expense or lease expenses, and the lease would not be included in a capital of the firm. Also by classifying it as an operating lease it will provide some tax incentives.

h. i. The ratios would help in analyzing the effect of capitalization of leases on the financial statements and performance of the company. Current Assets will not change if a company chooses to capitalize its leases. However, current liabilities would change if a company capitalized a lease, because the company will have a current portion of a lease liability. Current ratio is defined as total assets divided by total liabilities. Current ratio is a liquidity ratio that measures a company's ability to pay short-term and long-term obligations. Another ratio to consider is debt-to-equity ratio (total liabilities divided by stockholder's equity). Liabilities will increase and equity section would stay the same, which causes the ratio to increase. And the last ratio that could prove the difference would be long-term debt-to-equity ratio, which is long-term debt, divided by total assets. If the assets are capitalized, the assets and liabilities will increase at first and then decrease towards the end of the useful life. So the ratio is going to increase.

Ratio	Ratios before 2010	Ratios after 1/2/2010
Current Ratio	1.66	1.68
Debt-to-Equity Ratio	0.73	1.84
Long-term Debt-to-Equity	0.13	0.47