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Exploring the Financial and Accounting Reporting Standards and Principles under U.S. GAAP

Harrison B. P. Jensen
University of Mississippi

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Exploring the Financial and Accounting Reporting Standards and Principles under U.S. GAAP

By
Harrison Brian Pence Jensen

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 2019

Approved by

_____________________________
Advisor: Dr. Victoria Dickinson

_____________________________
Reader: Dr. W. Mark Wilder
HARRISON JENSEN: Exploring the Financial and Accounting Reporting Standards and Principles under U.S. GAAP

(Under the direction of Dr. Victoria Dickinson)

This text is an accumulation of case studies assigned by Dr. Victoria Dickson over the course of the Professional Research and Development Research Program offered to accounting undergraduate students at the University of Mississippi. Each case serves to highlight a unique component of the financial and accounting reporting standards and principles under U.S. GAAP. The content of this text also allowed for exploring the applicability of these topics with real world examples, like international accounting, data analytics, and stockholder’s equity. Ultimately, through the process of building this text, students conclude the experience with the knowledge of the expected capabilities of a certified public accountant and are left with a concrete understanding of the career opportunities available for public accountants.
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CASE STUDY 1: Glenwood Heating, Inc. Analysis
CASE STUDY 1: Glenwood Heating, Inc. Analysis

Case Description

Two Colorado companies who specialize in selling home heating units are curious as to which company is the more attractive to invest in from an outside perspective. The two companies at hand, Eads Heater, Inc. and Glenwood Heating, Inc. both operate in Colorado and share similar economic conditions and have seemingly ran identical operations during the year. However, each company’s respective manager appears to make opposing accounting choices and estimates when applying generally accepted accounting principles in preparing their Financial Statements. The main differences between the approaches were the methods of allowance for doubtful accounts, recording cost of goods sold, accounting for depreciation, paying for equipment, and allocating finances for tax reporting purposes.

Executive Summary

The information presented in this document will provide the financial findings and analysis necessary to determine why Glenwood Heating, Inc. is a better investment opportunity than Eads Heater.
Case Solution

Based upon the information gained from analyzing the data gathered from the financial statements of Glenwood Heating, Inc. and Eads Heater, Inc., and despite incurring larger expenses from their operations, Glenwood Heating, Inc. appears to collect a higher Net Income. Glenwood is able to achieve their superiority to Eads in two major areas.

First, it is important to note both companies purchased the exact same number of heating units at the same prices, and sold the same amount of units at the same price. With this knowledge, one can see why the method selected for allocating production costs could affect the Gross Profit of each company. Glenwood utilizes FIFO allocation when determining Cost of Goods Sold, allowing for them to spend $18,800 less than Eads, who uses LIFO (as demonstrated in Figure 1-1 and 1-2). Second, it is important to note that both companies purchased their respective land and buildings at the same price, expected life, and salvage value. When choosing their respective methods to record depreciation expense for the year, Glenwood used Straight-line depreciation to record depreciation for both their building and their delivery equipment. Eads, however, used Straight-line depreciation for their building, but Double-declining balance for their delivery equipment. This decision leads Eads to spend $1,000 more on depreciation per year than their competitor.
### Figure 1-1: Glenwood Heating, Inc. Income Statement

<table>
<thead>
<tr>
<th>Glenwood Heating, Inc</th>
<th>Income Statement</th>
<th>Year Ended Dec 31, 20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sales</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales Revenue</td>
<td></td>
<td>$398,500</td>
</tr>
<tr>
<td>Net</td>
<td></td>
<td>$398,500</td>
</tr>
<tr>
<td><strong>CGS</strong></td>
<td></td>
<td>$(177,000)</td>
</tr>
<tr>
<td><strong>Gross Profit</strong></td>
<td></td>
<td>$221,500</td>
</tr>
<tr>
<td><strong>Operating Expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bad Debts Expense</td>
<td></td>
<td>$994</td>
</tr>
<tr>
<td>Depreciation Expense</td>
<td></td>
<td>$19,000</td>
</tr>
<tr>
<td>Rent Expense</td>
<td></td>
<td>$16,000</td>
</tr>
<tr>
<td>Other Operating Expenses</td>
<td></td>
<td>$34,200</td>
</tr>
<tr>
<td>Net</td>
<td></td>
<td>$70,194</td>
</tr>
<tr>
<td><strong>Income from Operations</strong></td>
<td></td>
<td>$151,306</td>
</tr>
<tr>
<td><strong>Other Expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest Expense</td>
<td></td>
<td>$27,650</td>
</tr>
<tr>
<td>Income before taxes</td>
<td></td>
<td>$123,656</td>
</tr>
<tr>
<td>Income Tax Expense</td>
<td></td>
<td>$30,914</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td></td>
<td>$92,742</td>
</tr>
</tbody>
</table>
### Eads Heaters, Inc
#### Income Statement
##### Year Ended Dec 31, 20X1

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sales</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales Revenue</td>
<td></td>
<td>$398,500</td>
</tr>
<tr>
<td>Net</td>
<td></td>
<td>$398,500</td>
</tr>
<tr>
<td><strong>CGS</strong></td>
<td>$(188,800)</td>
<td></td>
</tr>
<tr>
<td><strong>Gross Profit</strong></td>
<td></td>
<td>$209,700</td>
</tr>
<tr>
<td><strong>Operating Expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bad Debts Expense</td>
<td></td>
<td>$4,970</td>
</tr>
<tr>
<td>Depreciation Expense</td>
<td></td>
<td>$41,500</td>
</tr>
<tr>
<td>Other Operating Expenses</td>
<td></td>
<td>$34,200</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$80,670</td>
</tr>
<tr>
<td><strong>Income from Operations</strong></td>
<td></td>
<td>$129,030</td>
</tr>
<tr>
<td><strong>Other Expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest Expense</td>
<td>$35,010</td>
<td></td>
</tr>
<tr>
<td>Income before Taxes</td>
<td></td>
<td>$94,020</td>
</tr>
<tr>
<td>Income Tax Expense</td>
<td>$23,505</td>
<td></td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td></td>
<td>$70,515</td>
</tr>
</tbody>
</table>
The only sign of possible hazard would be the $16,000 rental fee for additional equipment the company used this year, as the company did not agree to a fixed rate for the following years with the owner.

In conclusion, Glenwood Heating, Inc. would be the heating company I would select based on their ability to produce a notably larger income than their competitor despite their added costs with the equipment rental fee.
Appendices – Case Study 1: Glenwood Heating, Inc.

This appendices section includes information used to create the conclusions in the body of the case.

Appendix A-1: Remaining Statements, Balances, and Transactions

<table>
<thead>
<tr>
<th>Glenwood Heating, Inc</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Statement of Retained Earnings</strong></td>
</tr>
<tr>
<td><strong>Year Ended Dec 31, 20X1</strong></td>
</tr>
<tr>
<td>Debit</td>
</tr>
<tr>
<td>Beg Balance</td>
</tr>
<tr>
<td>Net Income</td>
</tr>
<tr>
<td>Dividends</td>
</tr>
<tr>
<td><strong>Ending Balance</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Eads Heaters, Inc</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Statement of Retained Earnings</strong></td>
</tr>
<tr>
<td><strong>Year Ended Dec 31, 20X1</strong></td>
</tr>
<tr>
<td>Debit</td>
</tr>
<tr>
<td>Beg Balance</td>
</tr>
<tr>
<td>Net Income</td>
</tr>
<tr>
<td>Dividends</td>
</tr>
<tr>
<td><strong>Ending Balance</strong></td>
</tr>
</tbody>
</table>
# Eads Heaters, Inc
## Balance Sheet
### Dec 31, 20X1

<table>
<thead>
<tr>
<th>Assets</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$ 7,835</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>$ 51,000</td>
<td></td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>$ 99,400</td>
<td></td>
</tr>
<tr>
<td>Less Allowance for DA</td>
<td>$ (4,970)</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$ 153,265</td>
<td></td>
</tr>
<tr>
<td><strong>Long Term Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>$ 80,000</td>
<td></td>
</tr>
<tr>
<td>Building</td>
<td>$ 350,000</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>$ 70,000</td>
<td></td>
</tr>
<tr>
<td>Leased Equipment</td>
<td>$ 92,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$ 592,000</td>
<td></td>
</tr>
<tr>
<td><strong>Less Acc Depreciation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>$ 20,000</td>
<td></td>
</tr>
<tr>
<td>Building</td>
<td>$ 10,000</td>
<td></td>
</tr>
<tr>
<td>Leased Equipment</td>
<td>$ 11,500</td>
<td></td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>$ 703,765</td>
<td></td>
</tr>
</tbody>
</table>

| Liabilities      |      |        |
| **Currents Liabilities** |      |        |
| Note Payable     | $ 380,000 |        |
| Accounts Payable | $ 26,440 |        |
| Interest Payable | $ 6,650 |        |
| **Total**        | $ 413,090 |        |
| **Long Term Liabilities** |      |        |
| Lease Payable    | $ 83,360 |        |
| **Total Liabilities** |      | $ 496,450 |

| Equity           |      |        |
| Common Stock     | $ 160,000 |        |
| Retained Earnings| $ 47,315 |        |
| **Total Equity** |      | $ 207,315 |

<p>| Total Liabilities and Equity |      | $ 703,765 |</p>
<table>
<thead>
<tr>
<th>Glenwood Heating, Inc</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance Sheet</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Dec 31, 20X1</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Current Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$ 426</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>$ 62,800</td>
<td></td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>$ 99,400</td>
<td></td>
</tr>
<tr>
<td>Less Allowance for DA</td>
<td>$(994)</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>$ 161,632</td>
</tr>
<tr>
<td><strong>Long Term Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>$ 80,000</td>
<td></td>
</tr>
<tr>
<td>Building</td>
<td>$ 350,000</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>$ 70,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>$ 500,000</td>
</tr>
<tr>
<td><strong>Less Acc Deprecation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>$ 9,000</td>
<td></td>
</tr>
<tr>
<td>Building</td>
<td>$ 10,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td></td>
<td>$ 642,632</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Current Liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Note Payable</td>
<td>$ 380,000</td>
<td></td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>$ 26,440</td>
<td></td>
</tr>
<tr>
<td>Interest Payable</td>
<td>$ 6,650</td>
<td></td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td></td>
<td>$ 413,090</td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common Stock</td>
<td>$ 160,000</td>
<td></td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>$ 69,542</td>
<td></td>
</tr>
<tr>
<td><strong>Total Equity</strong></td>
<td></td>
<td>$ 229,542</td>
</tr>
<tr>
<td><strong>Total Liabilities and Equity</strong></td>
<td></td>
<td>$ 642,632</td>
</tr>
</tbody>
</table>
CASE STUDY 2: Profitability and Earnings Persistence
CASE STUDY 2: Profitability and Earnings Persistence

Case Description

Molson Coors Brewing Company and their financial statements present themselves with interesting methods and information that allows for knowledge to be gained by studying their decisions. This case proposes many questions to be answered revolving around the explanation of income statements and further explaining its various idiosyncrasies. It also allows the reviewer to determine the successes and shortcomings of Molson Coors decisions on which items to include on their income statements.

Case Questions

a. What are the major classifications on an income statement?

There are several major sections of the income statement. The first of these is the Operating Section, which contains items like Sales on Revenue, Cost of Goods Sold, Selling Expenses and Administrative or General Expenses. The second major section is the Non-operating section, which includes other Revenues and Gains, as well as other Expenses and Losses. The remaining sections include:

1. Income Tax
2. Discontinued Operations
3. Noncontrolling Interest
4. Earnings Per Share
5. Net Income
b. Explain why, under U.S. GAAP, companies are required to provide “classified” income statements.

They are required to utilize “classified” income statements to provide specified information that presents company figures to assist in determining profitability, investment value, and creditworthiness.

c. In general, why might financial statement users be interested in a measure of persistent income?

Persistent income allows for companies to demonstrate the low risk associated with investing in their company, and the steadiness to their ability to turn a profit.

d. Define comprehensive income and discuss how it differs from net income.

Comprehensive income includes all changes in equity during a period except those resulting from distributions to owners. A company may prefer to use comprehensive income on their income statement instead of using net income to demonstrate how profitable they were before distributions to show their ability to provide dividends.

e. The income statement reports “Sales” and “Net sales.” What is the difference? Why does Molson Coors report these two items separately?

Sales show the gross overall revenue value of the company’s products sold. Net sales represent the company's revenue after allowing for the allocation of sales allowances, discounts, and returns. Molson Coors reports these items separately to display the value of the gross sales they will actually make. They are required to pay excise taxes, taxes
paid when certain goods are purchased. Since they are required to pay these from their sales, the value they end up making is lowered.

f. Consider the income statement item “Special items, net” and information in Notes 1 and 8. In general, what types of items does Molson Coors include in this line item? ii. Explain why the company reports these on a separate line item rather than including them with another expense item. Molson Coors classifies these special items as operating expenses. Do you concur with this classification? Explain.

Typically, Special Items are significant gains or losses in income the company does not expect to repeat the following year. Molson Coors includes in their special notes items such as income from selling their share of receiving interest from an unsuccessful joint venture. This income, however, is not from their main income source from sales of their product, therefore allowing it to fall under their Special Items tab. Molson Coors separates their special items because the sale was not a regular gain or loss, so listing it separately clarifies the company's performance. I do not agree with the decision to place the sale under operating expenses when they could have placed it under an “other gains and losses” tab to distinguish the source of income.

g. Consider the income statement item “Other income (expense), net” and the information in Note 6. What is the distinction between “Other income (expense), net” which is classified a nonoperating expense, and “Special items, net” which Molson Coors classifies as operating expenses?
Items that fall under the distinction of “Other income (expenses), net” are more typical transactions that occur throughout the course of a year when compared with those under the “Special Items, net” tab. While they themselves do not commonly occur, “Other income (expenses), net” occurs more frequently than the Special Items.

h. Refer to the statement of comprehensive income. What is the amount of comprehensive income in 2013? How does this amount compare to net income in 2013?

The comprehensive income for 2013 was $760.2 million, an amount significantly higher than the net income of $572.5 million. This occurs because the comprehensive income includes unrealized gains and losses that are not listed in the income statement such as subsidiaries, amortization, and foreign currency adjustments.

i. Consider the information on income taxes, in Note 7. What is Molson Coors’ effective tax rate in 2013?

The effective tax rate is calculated by dividing the company’s income tax (84 million) by their pre-tax income (654.5 million), which creates a rate of 12.8 percent. This rate is lower than the federal income tax of 35 percent in response to strategically choosing to base operations in Central Europe to take advantage of lower foreign tax rates.
CASE STUDY 3: Pearson Accounts Receivable
CASE STUDY 3: Pearson Accounts Receivable

Case Questions

a. What is an account receivable? What other names does this asset go by?

Account receivable refers to the account referencing money that a company has a right to receive due to the company’s provision of either goods or services to a customer. Other names could be receivables or trade receivables.

b. How do accounts receivable differ from notes receivable?

Accounts receivable is a current asset and operates as a payment for services or a product, while notes receivable is other asset and operates as a repayment of money lent.

c. What is a contra account? What two contra accounts are associated with Pearson’s trade receivables? What types of activities are captured in each of these contra accounts? Describe factors that managers might consider when deciding how to estimate the balance in each of these contra accounts.

A contra account refers to an account in which the balance has the opposite of the normal balance for that account classification. For example, a contra asset account has a credit balance instead of a debit balance associated with an asset account. The two contra asset accounts associated with Pearson’s trade receivables are Provision for bad and doubtful debts and Provision for sales return. Provision for bad and doubtful debts is an account receivable that has been highlighted having a high probability of not being
collected or there is a serious amount of doubt of the ability of the purchaser to pay off their account. Provision for sales return is an account to properly accord for customer returns of damaged or insufficient products to the seller. Often the allowances for bad and doubtful accounts are due to either previous financial interactions with the party or poor credit associated with the purchaser. The Allowance for sales return is created as a cautionary account based off previous years reports of returned items.

d. Two commonly used approaches for estimating uncollectible accounts receivable are the percentage-of-sales procedure and the aging-of-accounts procedure. Briefly describe these two approaches. What information do managers need to determine the activity and final account balance under each approach? Which of the two approaches do you think results in a more accurate estimate of net accounts receivable?

The percentage of sales method is produced on the concept that the amount of bad debt is based on an accumulation of sales, either total sales or credit sales. Based on previous years, a company can essentially estimate what percentage of the sales measure will not be collected. If a company takes a percentage of sales, the calculated amount is the amount of the related bad debt expense. The aging method is a percentage of receivables method that analyzes the age of the receivables. The more time a debt has been outstanding, there is a decrease in the likeliness that the balance will be collected. The aging method breaks down receivables based on the length of time each has been
outstanding and applies a higher percentage to older debts. I think the percentage of sales method produces a more accurate estimate of net accounts receivable.

e. If Pearson anticipates that some accounts will be uncollectible, why did the company extend credit to those customers in the first place? Discuss the risks that managers must consider with respect to accounts receivable.

Pearson can’t fully anticipate which specific accounts will end up uncollectible; however, they can anticipate that not all of the accounts will be collected. Therefore, a business must risk having uncollected accounts, but if they plan ahead for that general possibility, they can make goals and predictions accounting for those failed extensions of credit.

f. Note 22 reports the balance in Pearson’s provision for bad and doubtful debts (for trade receivables) and reports the account activity (“movements”) during the year ended December 31, 2009. Note that Pearson refers to the trade receivables contra account as a “provision.” Under U.S. GAAP, the receivables contra account is typically referred to as an “allowance” while the term provision is used to describe the current-period income statement charge for uncollectible accounts (also known as bad debt expense).
a. Use the information in Note 22 to complete a T-account that shows the activity in the provision for bad and doubtful debts account during the year. Explain, in your own words, the line items that reconcile the change in account during 2009.

In the T account in Figure 3-1, the debit of 5 represents the change from the exchange rates from the time of the initial sale to the time in which the cash was acquired, the credit of 26 increases the allowance and represents the new bad debt expense amount, the debit of 20 represents the written off bad debts from the year, and the credit of 3 represents the bad debt expenses from the company they acquired.

*Figure 3-1: 2009 Allowance for Doubtful Accounts*
b. Prepare the journal entries that Pearson recorded during 2009 to capture:

1) Bad and doubtful debts expense for 2009 (that is, the “income statement movements”)

   *Figure 3-2: Bad and doubtful debts expense for 2009 Journal Entries*

<table>
<thead>
<tr>
<th>Balance Sheet/Income Statement</th>
<th>Bad and Doubtful Debts Expense</th>
<th>£26,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Statement</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance Sheet</td>
<td>Provision for Bad and Doubtful Debts</td>
<td>£26,000,000</td>
</tr>
</tbody>
</table>

2) The write-off of accounts receivable (that is, the amount “utilised”) during 2009. For each account in your journal entries, note whether the account is a balance sheet or income statement account.

   *Figure 3-3: Bad and doubtful debts expense for 2009 Journal Entries*

<table>
<thead>
<tr>
<th>Balance Sheet/Income Statement</th>
<th>Provision for Bad and Doubtful Debts</th>
<th>£20,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance Sheet</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance Sheet</td>
<td>Trade Receivables</td>
<td>£20,000,000</td>
</tr>
</tbody>
</table>

   c. Where in the income statement is the provision for bad and doubtful debts expense included?

   This information would be found on the income statement.
g. Note 22 reports that the balance in Pearson’s provision for sales returns was £372 at December 31, 2008 and £354 at December 31, 2009. Under U.S. GAAP, this contra account is typically referred to as an “allowance” and reflects the company’s anticipated sales returns.

a. Complete a T-account that shows the activity in the provision for sales returns account during the year. Assume that Pearson estimated that returns relating to 2009 Sales to be £425 million. In reconciling the change in the account, two types of journal entries are required, one to record the estimated sales returns for the period and one to record the amount of actual book returns.

Figure 3-3: Allowance for Sales Returns and Allowances 2009
b. Prepare the journal entries that Pearson recorded during 2009 to capture,

1. the 2009 estimated sales returns

*Figure 3-4: Journal Entries for Pearson 2009*

<table>
<thead>
<tr>
<th>Balance Sheet/Income Statement</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Statement</td>
<td>Sales Returns and Allowances</td>
<td>€53,000,000</td>
</tr>
<tr>
<td>Balance Sheet</td>
<td>Provision for Sales Returns</td>
<td>€53,000,000</td>
</tr>
</tbody>
</table>

2. the amount of actual book returns during 2009. In your answer, note whether each account in the journal entries is a balance sheet or income statement account.

*Figure 3-5: Actual Returns for 2009*

<table>
<thead>
<tr>
<th>Balance Sheet/Income Statement</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance Sheet</td>
<td>Provision for Sales Returns</td>
<td>€71,000,000</td>
</tr>
<tr>
<td>Balance Sheet</td>
<td>Trade Receivables</td>
<td>€20,000,000</td>
</tr>
</tbody>
</table>

c. In which income statement line item does the amount of 2009 estimated sales returns appear?

This line item will appear in Net Sales.
CASE STUDY 4: Discontinued Operations
CASE STUDY 4: Discontinued Operations

Case Description

Dealing with discontinued operations in an income statement is a very difficult part of accounting for me, so this report seeks to explain how to create a multi-step income statement.

Case Proposed Problem:

The following information is related to Dickson Company for 2017:

Retained earnings balance, January 1, 2017: $980,000
Sales Revenue: $25,000,000
Cost of Goods Sold: $16,000,000
Interest Revenue: $70,000
Selling and Administrative Expenses: $4,700,000
Write-off of goodwill: $820,000
Income taxes for 2017: $1,244,000
Gain on the sale of investments: $110,000
Loss due to flood damage: $390,000
Loss on the disposition of the wholesale division (net of tax): $440,000
Loss on operations of the wholesale division (net of tax): $90,000
Dividends declared on common stock: $250,000
Dividends declared on preferred stock: $80,000

Dickinson Company decided to discontinue its entire wholesale operations (considered a discontinued operation) and to retain its manufacturing operations. On September 15, Dickinson sold the wholesale operations to Rogers Company. During 2017, there were 500,000 shares of common stock outstanding all year.

Prepare a multiple-step income statement and a retained earnings statement.
Case Solution:

When handling Discontinued Operations, it is important to know where to place the operations on the income statement. The discontinued operations are placed immediately following the laundry list of continuing operations, just before extraordinary items, and are included in determining Net Income. Additionally, the amount listed next to each item needs to be the amount net of tax, meaning tax has already been removed from their respective amounts. Thankfully in this problem the discontinued items (Loss on operations of the wholesale division and Loss on the disposition of the wholesale division) are already presented net of tax. Discontinued operations, via being factoring into Net Income, is important in a Retained Earnings Statement, so it is essential that the information is placed accordingly. Once that knowledge is obtained, produce the income statement and retained earnings statement.

1). When Preparing the income statement first list the company name, declare the document an income statement, and claim the date from which the information is being presented.

   DICKINSON COMPANY
   Income Statement
   For the Year Ended December 31, 2017

2). Next include all information from continuing operations and factor in income tax.

   Sales revenue ........................................................................................................ $25,000,000
   Cost of goods sold .............................................................................................. (16,000,000)
   Gross profit ....................................................................................................... 9,000,000
   Selling and administrative expenses ................................................................. (4,700,000)
   Income from operations ..................................................................................... 4,300,000
   Other revenues and gains
   Interest revenue ................................................................................................ $ 70,000
   Gain on the sale of investments ........................................................................ 110,000  (180,000)
   Other expenses and losses
   Write-off of goodwill ........................................................................................ (820,000)
   Income from continuing operations before income tax ........................................ 3,660,000
   Income tax .......................................................................................................... (1,244,000)
   Income from continuing operations .................................................................... 2,416,000
3). Next include information from discontinued operations, extraordinary items, and determine Net Income.

Discontinued operations
Loss on operations, net of applicable tax................................. 90,000
Loss on disposal, net of applicable tax ........................................ 440,000 (530,000)
Income before extraordinary item ............................................. 1,886,000
Extraordinary item—loss from flood damage, net of applicable tax ........................................................................ (390,000)
Net income ................................................................................ $ 1,496,000

4). Finally determine the information for earnings per share.

Earnings per share:
Income from continuing operations ........................................ $ 4.67(a)
Discontinued operations
Loss on operations, net of tax ................................................... $(0.18)
Loss on disposal, net of tax ....................................................... (0.88) (1.06)
Income before extraordinary item ............................................. 3.61(b)
Extraordinary loss, net of tax ..................................................... (0.78)
Net income ................................................................................ $ 2.83(c)

a. ($2,416,000 – $80,000) / 500,000 shares = $4.67

b. ($1,886,000 – $80,000) / 500,000 shares = $3.61

c. ($1,496,000 – $80,000) / 500,000 shares = $2.83

5). Prepare the retained earnings statement

DICKINSON COMPANY
Retained Earnings Statement
For the Year Ended December 31, 2017

Retained earnings, January 1 ...................................................... $ 980,000
Add: Net income ................................................................. (1,496,000) 2,476,000

Less Dividends declared on:
Preferred stock ................................................................. $ 80,000
Common stock ................................................................. 250,000 (330,000)
Retained earnings, December 31 ............................................ $ 2,146,000
CASE STUDY 5: Property, Plant and Equipment
CASE STUDY 5: Property, Plant and Equipment

Case Description

Palfinger AG manufactures offers equipment to be sold to companies in the construction, transport, agriculture and forestry, recycling, and haulage industries. This case study about their financial statements demonstrates examples of how foreign companies address various aspects of financial reporting for Property, Plant, and Equipment related assets. Specifically, the case asks for the determination of the examples of what items the company lists under PPE, and how they denote depreciation on various assets, sale on PPE items, and appropriate book values.

Executive Summary

The information presented in this document will provide the financial findings and analysis necessary to determine how Palfinger AG handles Property, Plant, and Equipment.

Case Solution

a. Based on the description of Palfinger above, what sort of property and equipment do you think the company has?

Given the industries Palfinger panders towards, they would possess several types of property and equipment including land, heavy machineries, warehouses, assembly line equipment, and trucks.
b. The 2007 balance sheet shows property, plant, and equipment of €149,990. What does this number represent?

That amount represents the present value of property, plant, and equipment less the respective associated depreciation expenses.

c. What types of equipment does Palfinger report in notes to the financial statements?

Palfinger reports having their own buildings and investments in third-party buildings, plant and machinery, various fixtures, fittings, and equipment in the notes of their financial statements.

d. In the notes, Palfinger reports “Prepayments and assets under construction.” What does this subaccount represent? Why does this account have no accumulated depreciation? Explain the reclassification of €14,958 in this account during 2007.

Prepayments and assets under construction refer to an entity of company operations that was not purchased by the company, but rather was built in house. Therefore since the entity has no pegged financial amount to be associated with since there was no purchase made, no depreciation can accumulate over time as there is no amount or predicted expected lifetime for the entity. Also, these assets that are “under construction” can only be depreciated once they are available for uses, so until then they remain in a sense of limbo until they begin serving their purpose.
e. How does Palfinger depreciate its property and equipment? Does this policy seem reasonable? Explain the trade-offs management makes in choosing a depreciation policy.

Palfinger uses straight-line depreciation to account for the depreciation of their property and equipment. This policy seems reasonable as many companies across their industry utilize the same method for their respective asset depreciation accounting. Management has several advantages and disadvantages to weigh when choosing a depreciation policy. Depending on the method they choose, they run the risk of disvaluing their entity above or below its actual value.

f. Palfinger routinely opts to perform major renovations and value-enhancing modifications to equipment and buildings rather than buy new assets. How does Palfinger treat these expenditures? What is the alternative accounting treatment?

Palfinger replaces investments and value enhancing investments by capitalizing them to their new investments. Replacement investments and value enhancing investments are capitalized and depreciated over either the new or the original useful life. In the case of asset disposals, the difference between the carrying amounts and the net realizable value is booked through the income statement in either other operating income or other operating expenses. An alternate method is to immediately capitalize and depreciate each individual improvement or added on purchase enhancement.
g. Use the information in the financial statement notes to analyze the activity in the “Property, plant and equipment” and “Accumulated depreciation and impairment” accounts for 2007. Determine the following amounts:

i. The purchase of new property, plant and equipment in fiscal 2007.
- PPE for 2007 ................................................................. 149,990
- PPE for 2006 ................................................................. (98,130)
- Net Increase in PPE ...................................................... 51,860
- Total accumulation and impairment, 2007 ....................... 79,269
- Total accumulation and impairment, 2006 ....................... (79,233)
- **Total purchase of new PPE, 2007 ....................... $51,896**

ii. Government grants for purchases of new property, plant and equipment in 2007. Explain what these grants are and why they are deducted from the property, plant, and equipment account.

A government grant for purchases of new property, plant, and equipment are amounts of financial assistance to help a company acquire an asset. It is deducted from property, plant, and equipment to lower the carrying value for the asset and balance the balance sheet to account for the borrowed amount.


- 12,557

- \( 13,799 - 12,298 = 1,501 \)

h. The statement of cash flows (not presented) reports that Palfinger received proceeds on the sale of property, plant, and equipment amounting to €1,655 in fiscal 2007. Calculate the gain or loss that Palfinger incurred on this transaction. Hint: use the net book value you calculated in part g iv, above. Explain what this gain or loss represents in economic terms.

In order to calculate the gain you need to subtract the NBV of the disposals of 1,501 from the proceeds of the sale 1,655 to declare a gain 154.

i. Consider the €10,673 added to “Other plant, fixtures, fittings, and equipment” during fiscal 2007. Assume that these net assets have an expected useful life of five years and a salvage value of €1,273. Prepare a table showing the depreciation expense and net book value of this equipment over its expected life assuming that Palfinger recorded a full year of depreciation in 2007 and the company uses:

i. Straight-line depreciation.

ii. Double-declining-balance depreciation.
### Table

<table>
<thead>
<tr>
<th>Method</th>
<th>Year</th>
<th>Book Value</th>
<th>Depr Exp</th>
<th>NRV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Straight-line</td>
<td>2007</td>
<td>10,673</td>
<td>1,880</td>
<td>8,793</td>
</tr>
<tr>
<td>Double Declining</td>
<td>2007</td>
<td>10,673</td>
<td>4,269</td>
<td>6,404</td>
</tr>
</tbody>
</table>

j. Assume that the equipment from part i. was sold on the first day of fiscal 2008 for proceeds of €7,500. Assume that Palfinger’s accounting policy is to take no depreciation in the year of sale.

i. Calculate any gain or loss on this transaction assuming that the company used straight-line depreciation. What is the total income statement impact of the equipment for the two years that Palfinger owned it? Consider the gain or loss on disposal as well as the total depreciation recorded on the equipment (i.e. the amount from part i. i.).

- $10,673 - 7,500 - 1,880 = 1,293$ consider that a loss on the disposal and the 1,880 as the depreciation amount, total difference 3,173

  Debit cash, accumulated depreciation, loss, credit equipment 10,673

ii. Calculate any gain or loss on this transaction assuming the company used double-declining balance depreciation. What is the total income statement impact of this equipment for the two years that Palfinger owned them? Consider the gain or
loss on disposal as well as the total depreciation recorded on the equipment (i.e. the amount from part i. ii.).

- 10,673 - 7,500 - 4,269 = 1,096 is a gain on the disposal and the 4,269 as the depreciation amount

Debit Cash, accumulated depreciation, credit equipment, gain

iii. Compare the total two-year income statement impact of the equipment under the two depreciation policies. Comment on the difference.

- The loss from using double declining is 27,000 euros more than straight-line.
CASE STUDY 6: Research and Development Costs
CASE STUDY 6: Research and Development Costs

Case Description

Volvo Group produces commercial vehicles to the likes of trucks, buses, construction equipment, engines and drive systems as well as aircraft engine components. Volvo Group annually invests roughly 13 billion Swedish Krona into their research and development division with a focus on creating unique, innovative technological advancements focused largely on reducing environmental impact and meeting future emissions and other regulations globally. Volvo Group also offers its customers financial solutions. This case study seeks to explore how a company of this nature accounts for all the various costs associated with a Research and Development division. Specifically, analyze the specifics behind the company’s unique bookkeeping, as well as expound upon some differences between U.S. GAAP and IFRS.

Executive Summary

The information presented in this document will provide the financial findings and analysis necessary to determine how Volvo Group handles Research and Development Costs.
Case Solution

a. The 2009 income statement shows research and development expenses of SEK 13,193 (millions of Swedish Krona). What types of costs are likely included in these amounts?

According to IAS 38, costs associated with Research activities include activities aimed at obtaining new knowledge; the search for, evaluation and final selection of, applications of research findings or other knowledge; the search for alternatives for materials, devices, products, processes, systems or services; and the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

According to IAS 38, costs associated with Development activities include the design, construction and testing of pre-production or pre-use prototypes and models; the design of tools, jigs, moulds and dies involving new technology; the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

b. Volvo Group follows IAS 38—Intangible Assets, to account for its research and development expenditures (see IAS 38 excerpts at the end of this case). As such, the company capitalizes certain R&D costs and expenses others. What factors does
Volvo Group consider as it decides which R&D costs to capitalize and which to expense?

Volvo group considers many factors as it decides which Research and Development Costs it should capitalize and which it should expense. According to IAS 38, no intangible assets from research will be recognized and any expenditure on research will be recognized as an expense when it is incurred. IAS 38 determines that under the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Therefore, this expenditure is recognized as an expense when it is incurred. An intangible asset arising from development shall be recognized if, and only if, an entity can demonstrate all of the following: the technical feasibility of completing the intangible asset so that it will be available for use or sale; its intention to complete the intangible asset and use or sell it; its ability to use or sell the intangible asset; or if the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset. Finally, the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset and its ability to measure reliably the expenditure attributable to the intangible asset during its development has an effect on determining how an intangible asset is to be expensed.
c. The R&D costs that Volvo Group capitalizes each period (labeled Product and software development costs) are amortized in subsequent periods, similar to other capital assets such as property and equipment. Notes to Volvo’s financial statements disclose that capitalized product and software development costs are amortized over three to eight years. What factors would the company consider in determining the amortization period for particular costs?

Volvo Group would consider many factors in determining the amortization period for particular costs including, the useful life of the products and the perceived benefit it has on producing future economic opportunities, and what the industry standards would be for determining amortization on the same types of intangibles.

d. Under U.S. GAAP, companies must expense all R&D costs. In your opinion, which accounting principle (IFRS or U.S. GAAP) provides financial statements that better reflect costs and benefits of periodic R&D spending?

Research and development under the IFRS method appears to have a lot of information that is subject to inference and making decisions based off estimated processes and individual judgment, whereas under U.S. GAAP, all costs are required to be expensed and the U.S. bookkeeping allows the R&D information to focus on the present state of the division. Therefore in my opinion, U.S. GAAP provides financial statements that better reflect costs and benefits of periodic R&D spending.
e. Refer to footnote 14 where Volvo reports an intangible asset for “Product and software development.” Assume that the product and software development costs reported in footnote 14 are the only R&D costs that Volvo capitalizes. What is the amount of the capitalized product and software development costs, net of accumulated amortization at the end of fiscal 2009? Which line item on Volvo Group’s balance sheet reports this intangible asset?

Total P&S Development Costs – Total Accumulated Depr. & Amortization = amount capitalized

25,148 - 13,739 = 11,499

This number would be reported as an Intangible Asset under the Assets section of the Balance Sheet.

f. Refer to Volvo’s balance sheet, footnotes, and the eleven-year summary. Assume that the product and software development costs reported in footnote 14 are the only R&D costs that Volvo capitalizes.

i. Complete the table below for Volvo’s Product and software development intangible asset.
**Figure 6-1: Volvo’s Product and software development intangible asset**

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product and software development costs capitalized during the year</td>
<td>2,507</td>
<td>2,150</td>
<td>1,858</td>
</tr>
<tr>
<td>Total R&amp;D expense on the income statement</td>
<td>11,509</td>
<td>14,348</td>
<td>13,193</td>
</tr>
<tr>
<td>Amortization of previously capitalized costs (included in R&amp;D expense)</td>
<td>2,357</td>
<td>2,864</td>
<td>3,126</td>
</tr>
<tr>
<td>Total R&amp;D costs incurred during the year = 1 + 2 - 3</td>
<td>10,759</td>
<td>13,634</td>
<td>11,925</td>
</tr>
</tbody>
</table>

**g. Assume that you work as a financial analyst for Volvo Group and would like to compare Volvo’s research and development expenditures to a U.S. competitor, Navistar International Corporation. Navistar follows U.S. GAAP that requires that all research and development costs be expensed in the year they are incurred. You gather the following information for Navistar for fiscal year end October 31, 2007 through 2009.**

**i. Use the information from Volvo’s eleven-year summary to complete the following table:**

**Figure 6-2: Volvo’s eleven-year summary**

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales, industrial operations</td>
<td>276,795</td>
<td>204,932</td>
<td>208,487</td>
</tr>
<tr>
<td>Total assets, from balance sheet</td>
<td>321,647</td>
<td>372,419</td>
<td>332,265</td>
</tr>
</tbody>
</table>
ii. Calculate the proportion of total research and development costs incurred to net sales from operations (called, net sales from manufactured products, for Navistar) for both firms. How does the proportion compare between the two companies?

*Figure 6-3: Volvo’s proportion of total R&D costs to net sales*

<table>
<thead>
<tr>
<th></th>
<th>Navistar (In U.S. $ Millions)</th>
<th>Volvo Group (In SEK millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2007</td>
<td>2008</td>
</tr>
<tr>
<td>Total Research and Development Costs</td>
<td>375</td>
<td>384</td>
</tr>
<tr>
<td>Nets Sales From Manufactured Products</td>
<td>11,910</td>
<td>14,399</td>
</tr>
<tr>
<td>Proportion of total research and development costs incurred to net sales from operations</td>
<td>3.15%</td>
<td>2.67%</td>
</tr>
</tbody>
</table>

Volvo incurred more proportional costs from their total research and development activities when compared with the American based Navistar.
CASE STUDY 7: Data Analytics Summary
CASE STUDY 7: Data Analytics Summary

Case Description

The purpose of this case was to research the role of a specific data and analytics tool to determine its role in the business decision-making processes of the current financial world. Specifically, my group researched the popular Microsoft D&A tool, Power BI. We researched the tools history, purpose for its creation, and, in general, how it is used to make business decision. In addition, the case seeks to provide examples of how to implement the useful components of the tool in the auditing, tax planning, and advisory settings. Finally, the case explains how the tool will impact the staffing and scope of our hypothetical future engagements with future public accounting partners.

Executive Summary

The information presented in this document will provide the findings and analysis necessary to determine how Microsoft Power BI is utilized in decision-making.

Case Solution

1. **Identify the history and purpose of this tool and describe, in general, how it is used to make business decisions. Be specific about what kind of technology platform it uses, etc. and other resources that need to fully utilize the functionality of the tool.**

Dhers and Amir Netz of the SQL Server Reporting Services Team at Microsoft originally created Microsoft Power BI. The program was initially designed by Ron George in the summer of 2010 and was originally named Project Crescent. It was
available for public download for the first time on July 11, 2011 bundled with SQL Server Codename Denali. Later Project Crescent was renamed to Power BI and was re-released by Microsoft in September of 2013 as Power BI for the Office 365 update. The release of Power BI was rooted in launching the Microsoft Excel–based add-ins: Power Query, Power Pivot and Power View. Since the initial release of the tool, Microsoft added several additional features like Question and Answers, enterprise level data connectivity, and security options via Power BI Gateways. Power BI was first released to the general public on July 24, 2015 (Wikipedia).

Power BI exists as a cloud-based business analytics service that gives you a single view of your most critical business data. The tool connects users to hundreds of data sources, simplify the data prep process, and drive the usage of ad hoc analysis. The tool helps users produce beautiful reports, publish them for your organization to consume on the web and across mobile devices and create personalized dashboards with a unique, 360-degree view of their business to improve the monitoring of hundreds of financial indicators of their business performance (Microsoft).

2. What special skills are needed to used the tool to aid in business decision-making. How might a student like yourself gain those skills?

The Microsoft Power BI webpage provides a guided learning program that teaches users how to use the entire program from scratch to utilize services that monitor their company’s big data information. While no prior special skills are required, it appears that a solid understand of financial statements, general financial indicators, and a
relative Excel background would serve as a strong springboard to being able to take full advantage of the Power BI services (Microsoft).

3. **How, specifically, would you use the tool in the following business settings?**

   Create at least three specific scenarios for each category in which the tool would lead to more efficiency and/or better effectiveness. Be sure to describe what kinds of data your tool would use for each scenario.

   a. **Auditing**

      When setting up a meeting to assess the state of the audit, using Power BI Group allows all members, via the cloud, to be accessing and editing their data analysis systems in live time despite not being in the same location.

      The Power BI desktop allows centrality of information to integrate actively updating information, such as Total Revenue, and provide easy to read/understand the implications of that information in the forms of graphs, etc.

      When tasked with multiple clients, who use various big data collecting tools like Hadoop and Spark, Power BI integrates all the information those two sources possess and provides you several avenues of interpreting the data for your client.

   b. **Tax Planning**

      When deciding between different avenues for tax plans for a company, Power BI has many tools that build upon basic Excel properties to create easy to read forecasts that allow for infinite factors to be taken into consideration when optimizing tax planning.
The actively self-updating component of the tool has the ability to provide an accurate to the moment valuation for the amount of taxes companies will have to pay in each respective category.

The premium version allows anyone associated with the planning process to have access to the editing and viewing tools without purchasing individual licenses for each recipient.

c. Financial Statement Analysis/Valuation/Advisory

With the campaign/brand management solution application, we can amass data from Facebook, Twitter, etc. to improve our ability to understand the public perception of our clients, and be able to factor in non-financial information into our strategic advising work.

The Dynamics 365 Sales Analytics tool will allow firms to have up-to-date financial information from Sales to build models to predict future trends and understand recent trends.

Use SAP and Power BI to interpret Accounts Receivable accounts by tracking when the respective accounts are paid or added to a clients’ customer list.

4. Write a few paragraphs to your future public accounting partner explaining why your team should invest in the acquisition of and training in this tool. Explain how the tool will impact the staffing and scope of your future engagements.

Since we are still rely heavily on Microsoft computers and systems, I think we should seek to integrate Microsoft Power BI into our day-to-day operations with the
To acquire the licensing and implementation of the service, it will cost us around $75,000 a month for our 5,000 employees. While that number may initially seem high, the training is free, as Microsoft has provided an easy, video/interactive based learning process to get our firm up to speed in a weeks time. In addition, the consolidation and accessibility to information will create opportunities to make our operations more efficient and improve our turn around time on producing reports and analysis for our clients.

As of right now, we have been relying on excel as our only tool to accumulate and produce information to interpreted by our clients. With this new program, we will be able to utilize a more integrated system that allows for databases to be accessed in a more centralized location. This will allow our firm to keep that data within the same application for easy access when we are creating financial statements and graphical representations of our clients’ information. The desktop features are also shareable, and will allow for all members assigned to a project to be able to have constantly updated information and always be prepped on their clients’ current financial standings as well as be able to discern trends thanks to the various algorithms of the Power BI software.

In conclusion, the Power BI tool will allow our company to interpret big data in ways we were in capable of before with just Excel. It serves as an ability to amass, structure, and interpret data all within one application and, thanks to the cloud, is able to work with that information anywhere, with our entire team, anytime. This will allow our
processes to improve to become more efficient and more readily accessible for the members of our firm to work with, and for our clients to receive our work faster and in a more concise method.
CASE STUDY 8: Long-Term Debt
CASE STUDY 8: Long-Term Debt

Case Description

The purpose of this case was to discuss the principles of Long Term Debt and use Rite Aid Corporation’s financial statements to analyze how it behaves. Rite Aid is the third largest retail pharmacy in the U.S and number one in over half of the markets where it operates. In this case, we experimented with the straight-line method and effective interest rate method to determine the differing results from using those methods. We identified different types of debts like senior, fixed-rate, and convertible. Ultimately, the case provided an opportunity to discover the detailed specificities of Long Term Debt, and its role in the balance sheet.

Executive Summary

The information presented in this document will provide the findings and analysis necessary to study Long Term Debt.

Case Solution

a). Consider the various types of debt described in note 11, Indebtedness and Credit Agreement.

   i. Explain the difference between Rite Aid’s secured and unsecured debt.

Why does Rite Aid distinguish between these two types of debt?

   Rite Aid distinguishes these two types of debt because some form of collateral supports their secured debt; unsecured debt has no offered collateral. This occurs
because secured debt is associated with a higher amount of overall risk when compared with unsecured debt.

ii. What does it mean for debt to be “guaranteed”? According to note 11, who has provided the guarantee for some of Rite Aid’s unsecured debt?

A guaranteed loan is a loan financially backed by a third party in case the borrower of the loan defaults. Occasionally, the guaranteed loan is backed by a government agency, which will purchase the debt from the lending financial institution and take on responsibility for the loan. However, in the case of Rite Aid, they are a parent company that has supported the outstanding debts of a few of their subsidiaries.

iii. What is meant by the terms “senior,” “fixed-rate,” and “convertible”?

Senior debt is debt that takes priority over other unsecured debt owed by the issuer. Fixed rate debt is a type of debt that will pay a fixed interest rate to guarantee the loaning entity a constant interest rate payment every period. Convertible debt is simply a bond that can be converted into various predetermined amounts of the underlying company's equity.

iv. Speculate as to why Rite Aid has many different types of debt with a range of interest rates.

Since Rite Aid acts as a parent company to its various subsidiaries, they will in turn have many different types of debt. Since each of those subsidiaries issued bonds or gained various types of debts occurred at different times, the market rate would be different in each of those occurrences.
b). Consider note 11, Indebtedness and Credit Agreement. How much total debt does Rite Aid have at February 27, 2010? How much of this is due within the coming fiscal year? Reconcile the total debt reported in note 11 with what Rite Aid reports on its balance sheet.

As of February 27, 2010, Rite Aid has accumulated $6,370,899 in total debt. Of which, $51,502 is due within the coming fiscal year. The total debt reported in note 11 comes from the Rite Aid balance sheet’s information and is a collection of the company’s long-term debt due within the coming fiscal year, other long-term debts, and the company’s lease financing obligations.

c). Consider the 7.5% senior secured notes due March 2017.

i. What is the face value (i.e. the principal) of these notes? How do you know?

The face value of these notes due in March 2017 is $500,000 and we know this because the face value stays the same every year.

ii. Prepare the journal entry that Rite Aid must have made when these notes were issued.

\[
\begin{array}{cc}
\text{Cash} & 500,000 \\
\text{Bonds Payable} & 500,000 \\
\end{array}
\]

iii. Prepare the annual interest expense journal entry. Note that the interest paid on a note during the year equals the face value of the note times the stated rate (i.e., coupon rate) of the note.
iv. Prepare the journal entry that Rite Aid will make when these notes mature in 2017.

\[
\begin{align*}
\text{Bonds Payable} & \quad 500,000 \\
\text{Cash} & \quad 500,000
\end{align*}
\]

d). Consider the 9.375% senior notes due December 2015. Assume that interest is paid annually.

i. What is the face value (or principal) of these notes? What is the carrying value (net book value) of these notes at February 27, 2010? Why do the two values differ?

The face value of these notes due in December 2015 is $410,000 and the carrying value of these notes $405,951. The face and carrying value differ due to them being issued at a discount.

ii. How much interest did Rite Aid pay on these notes during the fiscal 2009?

During the fiscal year 2009, Rite Aid paid $38,438 in interest on these notes.

iii. Determine the total amount of interest expense recorded by Rite Aid on these notes for the year ended February 27, 2010. Note that there is a cash and a noncash portion to interest expense on these notes because they were issued at a discount. The noncash portion of interest expense is the amortization of the discount.
during the year (that is, the amount by which the discount decreased during the year).

Rite Aid recorded $39,143 in total interest expenses ($38,438 in cash, $705 in amortized discounts).

iv. Prepare the journal entry to record interest expense on these notes for fiscal 2009. Consider both the cash and discount (noncash) portions of the interest expense from part iii above.

<table>
<thead>
<tr>
<th>Interest Expense</th>
<th>39,143</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discount on Bonds Payable</td>
<td>705</td>
</tr>
<tr>
<td>Cash</td>
<td>38,438</td>
</tr>
</tbody>
</table>

v. Compute the total rate of interest recorded for fiscal 2009 on these notes.

The total rate of interest recorded for the fiscal year of 2009 was 9.64%.

e). Consider the 9.75% notes due June 2016. Assume that Rite Aid issued these notes on June 30, 2009 and that the company pays interest on June 30th of each year.

i. According to note 11, the proceeds of the notes at the time of issue were 98.2% of the face value of the notes. Prepare the journal entry that Rite Aid must have made when these notes were issued.

<table>
<thead>
<tr>
<th>Cash</th>
<th>402,620</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discount on Notes Payable</td>
<td>7,380</td>
</tr>
</tbody>
</table>
ii. At what effective annual rate of interest were these notes issued?

The effective annual rate of interest when these notes were issued was 10.1212%
CASE STUDY 9: Stockholder’s Equity
CASE STUDY 9: Stockholder’s Equity

Case Description

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 whom are engaged in research activities. The company’s shares are listed on the New York and Philadelphia Stock Exchanges. This case study seeks to explore how a company of this nature accounts for all the various costs associated with a Shareholders’ Equity. Specifically, we researched how to interpret shareholders’ equity disclosures, how to explain why companies pay dividends, how to explain why companies repurchase their stock, and how to compare accounting treatment of shareholders’ equity accounts.

Executive Summary

The information presented in this document will provide the financial findings and analysis necessary to determine how Volvo Group handles Research and Development Costs.

Case Solutions

a. Consider Merck’s common shares.

How many common shares is Merck authorized to issue?

5,400,000,000 shares
How many common shares has Merck actually issued at December 31, 2007?
2,983,508,675 shares

Reconcile the number of shares issued at December 31, 2007, to the dollar value of common stock reported on the balance sheet.
The 2,983,508,675 shares of the 1 cent par value equals the $29.8 million in common stock.

How many common shares are held in treasury at December 31, 2007?
811,005,791 shares

How many common shares are outstanding at December 31, 2007?
2,172,502,884 shares

At December 31, 2007, Merck’s stock price closed at $57.61 per share. Calculate the total market capitalization of Merck on that day.
$125,157,891,147.24

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?
The payment of dividends, either common or stock, acts as evidence to their shareholders that the company is financially stable enough to afford setting aside a set amount of funds to repay their shareholders trust for investing in the company in the first place. A company’s share price normally decrease after dividends are paid. This happens because after dividends are paid, the anticipation for potential dividends is
depleted since there is no longer a growing accumulation of funding for dividends immediately after the most recent paid dividends have been recorded.

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

Companies repurchase their own shares for a multitude of reasons. A company may want to centralize their ownership and choose to buy back some treasury stock. A company could also want to improve their EPS and choose to achieve that by decreasing the amount of outstanding shares in the market.

e. Consider Merck’s statement of cash flow and statement of retained earnings.

Prepare a single journal entry that summarizes Merck’s common dividend activity for 2007.

<table>
<thead>
<tr>
<th>Dividends Declared</th>
<th>3,310,700,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>3,307,300,000</td>
</tr>
<tr>
<td>Dividends Payable</td>
<td>3,400,000</td>
</tr>
</tbody>
</table>

g. During 2007, Merck repurchased a number of its own common shares on the open market.

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

Merck elected to use the cost method to account for treasury stock transactions. The cost method can be identified as the style Merck used since the amount they recorded treasury stock for was at the amount in which is was repurchased rather than the amount it was initially sold for.
ii. Refer to note 11 to Merck’s financial statements. How many shares did Merck repurchase on the open market during 2007?

26,500,000 million shares

iii. How much did Merck pay, in total and per share, on average, to buy back its stock during 2007? What type of cash flow does this represent?

Merck paid $1,429,700,000 in total to buy back its stock, at an average of $53.95/share. This represents a financing cash flow.

iv. Why doesn’t Merck disclose its treasury stock as an asset?

The actions of reselling or purchasing back treasury stock do not affect the company’s net income, therefore it can not be disclosed as an asset.

i. Determine the missing amounts and calculate the ratios in the tables below. Use the number of shares outstanding at year end for per-share calculations. What differences do you observe in Merck’s dividend-related ratios across the two years?

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends paid</td>
<td>$3,307,300,000</td>
<td>$3,322,600,000</td>
</tr>
<tr>
<td>Shares outstanding</td>
<td>2,172,500,000</td>
<td>2,167,800,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$3,275,400,000</td>
<td>$4,433,800,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$48,350,700,000</td>
<td>$44,569,800,000</td>
</tr>
<tr>
<td>Operating cash flows</td>
<td>$6,999,200,000</td>
<td>$6,765,200,000</td>
</tr>
<tr>
<td>Year-end stock price</td>
<td>$57.61</td>
<td>$41.94</td>
</tr>
<tr>
<td>Dividends per share</td>
<td>$1.52</td>
<td>$1.53</td>
</tr>
<tr>
<td>Dividend yield (Dividends per share to stock price)</td>
<td>2.64%</td>
<td>3.65%</td>
</tr>
<tr>
<td>Dividend payout (dividends to net income)</td>
<td>1.01</td>
<td>.75</td>
</tr>
<tr>
<td>Dividends to total assets</td>
<td>6.84%</td>
<td>7.45%</td>
</tr>
<tr>
<td>Dividends to operating cash flow</td>
<td>47.25%</td>
<td>49.11%</td>
</tr>
</tbody>
</table>
When comparing the two years, the dividend ratios remained rather unchanged, however there were certainly decreases seen in the price per share category and the company’s net income.
CASE STUDY 10: Marketable Securities
CASE STUDY 10: Marketable Securities

Case Description

State Street Corporation is a major financial holding company with headquarters in Boston, MA. State Street operates primarily through its principal banking subsidiary, State Street Bank and Trust, with a focus on serving institutional investors. State Street operates two lines of business, Investment Servicing and Investment Management, to support institutional investors worldwide. Products include brokerage and other trading services, securities finance, deposit and short-term investment facilities, performance, risk and investment research and investment management. The case asks us to distinguish among securities classified as trading, available-for-sale, and held-to-maturity; interpret footnote disclosures of investment securities and analyze investment security accounts; prepare journal entries for securities purchases, sales, and year-end market-value adjustments; and understand and critique the accounting treatment for marketable securities.

Executive Summary

The information presented in this document will provide the financial findings and analysis necessary to determine how State Street Corporation handles their securities within their financial statements.

Case Solution

a. Consider trading securities. Note that financial institutions such as State Street typically call these securities “Trading account assets.”
i. In general, what are trading securities?

Trading securities is a category of securities that includes both debt and equity securities, and which an entity intends to sell in the short term for a profit that it expects to generate from increases in the price of the securities. This is the most common classification used for investments in securities. Trading securities are recorded in the balance sheet of the investor at their fair value as of the balance sheet date. This type of marketable security is always positioned in the balance sheet as a current asset.

ii. How would a company record $1 of dividends or interest received from trading securities?

Cash $1
Dividend Revenue $1
Cash $1
Interest Revenue $1

iii. If the market value of trading securities increased by $1 during the reporting period, what journal entry would the company record?

Trading Account Assets $1
Unrealized Holding Gain $1

b. Consider securities available-for-sale. Note that State Street calls these, “Investment securities available for sale.”

i. In general, what are securities available-for-sale?
An available-for-sale security (AFS) is a debt or equity security purchased with the intent of selling before it reaches maturity, or holding it for a long period should it not have a maturity date. Accounting standards necessitate that companies classify any investments in debt or equity securities when they are purchased as held to maturity, held for trading or available for sale. Available-for-sale securities are reported at fair value; changes in value between accounting periods are included in comprehensive income until the securities are sold.

**ii. How would a company record $1 of dividends or interest received from securities available-for-sale?**

Cash $1

Dividend Revenue $1

Cash $1

Interest Revenue $1

**iii. If the market value of securities available-for-sale increased by $1 during the reporting period, what journal entry would the company record?**

Investment Securities Available For Sale $1

Unrealized Holding Gain (Other Comp. Income) $1

c. Consider securities held-to-maturity. Note that State Street calls these, “Investment securities held to maturity.”
i. In general, what are these securities? Why are equity securities never classified as held-to-maturity?

A held-to-maturity security is purchased with the intention of holding the investment to maturity. This type of security is reported at amortized cost on a company's financial statements and is usually in the form of a debt security with a specific maturity date.

ii. If the market value of securities held-to-maturity increased by $1 during the reporting period, what journal entry would the company record?

No entry is required to report the $1 increase.

d. Consider the “Trading account assets” on State Street’s balance sheet.

i. What is the balance in this account on December 31, 2012? What is the market value of these securities on that date?

The balance and the market value of the Trading Account Assets is $637,000,000 because the securities are listed at their fair value.

ii. Assume that the 2012 unadjusted trial balance for trading account assets was $552 million. What adjusting journal entry would State Street make to adjust this account to market value? Ignore any income tax effects for this part.

<table>
<thead>
<tr>
<th>Trading Account Assets</th>
<th>$85,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized Holding Gain</td>
<td>85,000,000</td>
</tr>
</tbody>
</table>
e. Consider the balance sheet account “Investment securities held to maturity” and the related disclosures in Note 4.

   i. What is the 2012 year-end balance in this account?

      The 2012 year-end balance in this account is $11,379,000,000.

   ii. What is the market value of State Street’s investment securities held to maturity?

      The market value of State Street’s investment securities held-to-maturity is $11,661,000,000.

   iii. What is the amortized cost of these securities? What does “amortized cost” represent? How does amortized cost compare to the original cost of the securities?

      The amortized cost of these securities is equal to $11,379,000,000. The original cost is higher than the amortized cost because the amortized cost represents the carrying value of the securities.

   iv. What does the difference between the market value and the amortized cost represent? What does the difference suggest about how the average market rate of interest on held-to-maturity securities has changed since the purchase of the securities held by State Street?

      The market value is the value the investment currently has if purchased out on the open market. The amortized cost is the accumulated portion of the recorded cost of a fixed asset that has been charged to expense through either depreciation or amortization.
f. Consider the balance sheet account “Investment securities available for sale” and the related disclosures in Note 4.

i. What is the 2012 year-end balance in this account? What does this balance represent?

The 2012 year-end balance in this account is $109,162,000,000. This balance also represents the market value.

ii. What is the amount of net unrealized gains or losses on the available-for-sale securities held by State Street at December 31, 2012? Be sure to note whether the amount is a net gain or loss.

The net unrealized gain on the available-for-sale securities is $1,119,000,000.

iii. What was the amount of net realized gains (losses) from sales of available-for-sale securities for 2012? How would this amount impact State Street’s statements of income and cash flows from 2012?

The net realized gain on the available-for-sale securities is $55,000,000. This amount increases State Street’s statements of income and their investing cash flows from 2012.

g. State Street’s statement of cash flow for 2012 (not included) shows the following line items in the “Investing Activities” section relating to available-for-sale securities (in millions): Proceeds from sales of available-for-sale securities $5,399 Purchases of available-for-sale securities $60,812
i. Show the journal entry State Street made to record the purchase of available-for-sale securities for 2012.

Investment Securities Available For Sale 60,812
Cash 60,812

ii. Show the journal entry State Street made to record the sale of available-for-sale securities for 2012. Note 13 (not included) reports that the available-for-sale securities sold during 2012 had “unrealized pre-tax gains of $67 million as of December 31, 2011.” Hint: be sure to remove the current book-value of these securities in your entry.

Cash 5,399
Unrealized Holding Gain – Other Compr. Income 67

Net Realized Holding Gains 55
Debt Investments 5,411

iii. Use the information in part g. ii to determine the original cost of the available-for-sale securities sold during 2012.

The original cost of the available-for-sale securities was $5,344,000,000.
CASE STUDY 11: Zagg, Inc. Deferred Income Taxes
CASE STUDY 11: Zagg, Inc. Deferred Income Taxes

Case Description

ZAGG Inc. began designing protective, plastic shields for wristwatches in 2005. Today the company is a market leader in mobile device accessories. ZAGG’s patented invisibleSHIELD film protects tablet and smartphone screens around the world. Their product list also includes mobile keyboards, cases, headphones, and portable power. In 2011, ZAAG acquired iFrogz, a manufacturer of digital audio accessories, in order to grow their product lines and expand distribution. ZAGG is currently traded on the NASDAQ. This case seeks to understand the concepts underlying deferred income tax accounting, interpret the three primary disclosures provided in the income tax footnote to the financial statements, and use deferred income tax asset and liability information to infer the magnitude of differences between book and tax income and asset values.

Executive Summary

The information presented in this document will provide the financial findings and analysis necessary to determine how ZAGG Inc. handles their Deferred Income Taxes within their financial statements.

Case Solution

a. Describe what is meant by the term book income? Which number in ZAGG’s statement of operation captures this notion for fiscal 2012? Describe how a company’s book income differs from its taxable income.
The term book income is typically defined as the income reported within the financial statements of the taxable entity under GAAP. ZAGG’s statement of operation states $23,898,000 for the amount of income before provision for income taxes. A company’s taxable income differs from their book income because the accounting methods for computing taxable income are not confined by any rulings from GAAP.

b. In your own words, define the following terms:

i. **Permanent tax differences (also provide an example)**

Permanent tax differences are defined as business transactions that are accounted for differently with financial and tax reporting purposes, in which the difference of the two will not be eliminated. Permanent tax differences occur when the complete elimination of a tax liability is highly desirable, since it permanently reduces the tax liability of a business. Penalties and fines are examples of permanent tax differences.

ii. **Temporary tax difference (also provide an example)**

Temporary tax differences are the temporary differences that will produce taxable amounts in the future when determining taxable profit or loss. Accumulated Depreciation is an example of a temporary tax difference.

iii. **Statutory tax rate**

The statutory tax rate is the tax rate enforced by the government. The exact tax rate depends on one’s level of income in which people of similar income levels receive the same tax rates.

iv. **Effective tax rate**
The effective tax rate is found by dividing the total tax expense divided by the total taxable income. The rate represents the average tax rate for the entirety of taxable income.

c. Explain in general terms why a company reports deferred income taxes as part of their total income tax expense. Why don’t companies simply report their current tax bill as their income tax expense?

A company reports deferred income taxes as a part of their total income tax expense to comply with ASC 740. According to PwC, “ASC 740-10-15-4 indicates that a withholding tax for the benefit of the recipients of a dividend is not an income tax of the entity that pays the dividend if certain conditions are met. We believe that this guidance would also apply to withholding taxes for the benefit of the recipients of interest, royalty, or other payments if those same conditions are satisfied.”

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 Income Tax Asset is an asset that appears on a company’s balance sheet with the purpose of providing an avenue that can be used to reduce taxable income. A DTA is also the opposite of a deferred income tax liability, which describes something that will be held to increase income tax in the future. Both items are presented on the company’s balance sheet under the Current Assets heading. A deferred tax asset is
created when the company’s recorded income taxes payable are computed to equal a number higher than the amount calculated for the income taxes paid to the government in that year.

A real world example of a deferred income tax asset occurs when a company is paid rental fees in advance of their client’s stay and that amount is taxed. This situation places the company responsible for tax obligations prior to the fulfillment of the rental, thus causing a deferred tax asset.

Since a deferred income tax liability occurs when a company has to pay taxes in the future, a common real world example of this is found in accounting for depreciation tax expenses. A deferred tax liability occurs when the amount of depreciation booked for tax purposes exceeds the depreciation amount listed within the company’s financial statements.

e. Explain what a deferred income tax valuation allowance is and when it should be recorded.

A deferred income tax valuation allowance is an item found on the balance sheet whose purpose is to counter the deferred tax asset account. A deferred tax valuation allowance account should be recorded when it is more than likely a company will not be able to receive the full valuation of the valuation.
f. Consider the information disclosed in Note 8 – Income Taxes to answer the following questions:

   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 9,393,000
   Net deferred income tax 8,293,000
   Income taxes payable 17,686,000

   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.

   The net effect of the deferred income tax asset and deferred income tax liability results in the “net deferred income tax” debit of $8,293,000. The deferred tax asset amount is calculated by debiting the increase from $6,300,000 in 2011 to $14,302,000 in 2012 of $8,002,000. The deferred tax liability amount is calculated by debiting the decrease from $1,086,000 in 2011 to $794,000 in 2012 of $292,000.

   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?
ZAGG’s effective tax and statutory rates differ from one another most likely due to changing tax rates or a large permanent difference taken on in 2012.

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. Explain where this amount appears on ZAGG’s balance sheet.

The net deferred income tax asset amount is a combination of the deferred income tax assets for the current year ($6,912,000) and the deferred income tax assets that will affect the company in the future ($6,596,000).
CASE STUDY 12: Apple, Inc. Revenue Recognition
CASE STUDY 12: Apple, Inc. Revenue Recognition

Case Description

Apple Inc. designs, manufactures, and markets personal computers, mobile communication devices, and portable digital music and video players and sells a variety of related software, services, peripherals, and networking solutions. The Company sells its products worldwide through its online stores, its retail stores, its direct sales force, and third-party wholesalers, resellers, and value-added resellers. The learning objectives of this case were to define revenues and gains, explain the difference between the revenues and gains, critically assess a company’s revenue recognition policies, and explain multiple-element contracts and understand their accounting complexities.

Executive Summary

The information presented in this document will provide the financial findings and analysis necessary to determine how Apple Inc. handles revenue recognition within their financial statements.

Case Solution

a. In your own words, define “revenues.” Explain how revenues are different from “gains.”

Revenues refer to the amount of money that a company actually receives during a specific period, including discounts and deductions for returned merchandise. Gains, and losses for that matter, are the opposite financial results occurring through a company's
nonprimary operations and production processes. Any time a company produces profit or realizes increased value through secondary sources, such as lawsuits, investments or disposal of assets, it is called a gain. Therefore the main difference between revenues and gains are the inherent place they have in the company’s main operations or lack thereof and the type of income they provide.

b. Describe what it means for a business to “recognize” revenues. What specific accounts and financial statements are affected by the process of revenue recognition? Describe the revenue recognition criteria outline in the FASB’s Statement of Concepts No. 5.

Once a company has established a performance obligation with a client via a contract, they are entitled to receive a form of financial compensation from the client for completing the obligation. The act of recognizing establishes that the performance obligation has been completed. The revenue recognition criteria includes:

1. Identify the contract with customers.
2. Identify the separate performance obligations in the contract.
3. Determine the transaction price
4. Allocate the transaction price to the separate performance obligations.
5. Recognize revenue when each performance obligation is satisfied

c. Refer to the Revenue Recognition discussion in Note 1. In general, when does Apple recognize revenue? Explain Apple’s four revenue recognition criteria. Do
they appear to be aligned with the revenue recognition criteria you described in part b, above?

According to their most recent 10-K, Apple recognizes revenue “when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable and collection is probable. Product is considered delivered to the customer once it has been shipped and title, risk of loss and rewards of ownership have been transferred. For most of the Company’s product sales, these criteria are met at the time the product is shipped. For online sales to individuals, for some sales to education customers in the U.S., and for certain other sales, the Company defers revenue until the customer receives the product because the Company retains a portion of the risk of loss on these sales during transit. For payment terms in excess of the Company’s standard payment terms, revenue is recognized as payments become due unless the Company has positive evidence that the sales price is fixed or determinable, such as a successful history of collection, without concession, on comparable arrangements. The Company recognizes revenue from the sale of hardware products, software bundled with hardware that is essential to the functionality of the hardware and third-party digital content sold on the iTunes Store in accordance with general revenue recognition accounting guidance. The Company recognizes revenue in accordance with industry-specific software accounting guidance for the following types of sales transactions: (i) standalone sales of software products, (ii) sales of software upgrades and (iii) sales of software bundled with hardware not essential to the functionality of the hardware.”
d. What are multiple-element contracts and why do they pose revenue recognition problems for companies?

A multiple-element contract that a company has with one specific customer to deliver multiple services or goods under one contract. Multiple-element contracts can create problems for companies like Apple because it can be difficult to determine what revenue should be recognized from the sale of an item like an iPhone that contains the device itself but also the software for the product.

e. In general, what incentives do managers have to make self-serving revenue recognition choices?

Managers at companies like Apple are often incentivized to make self-serving revenue recognition choices by the possibility of receiving a bonus if they surpass a certain quota threshold of number of devices sold or a commission on a per item basis for their total sales amount. Therefore they may make choices to pair certain revenues with certain expenses in order to maximize their opportunity for extra compensation added to their paychecks.

f. Refer to Apple’s revenue recognition footnote. In particular, when does the company recognize revenue for the following types of sales?

i. iTunes songs sold online.

Apple recognizes revenue for iTunes songs sold online in accordance with industry specific software accounting guidance for the following types of sales
transactions: (i) standalone sales of software products, (ii) sales of software upgrades and (iii) sales of software bundled with hardware not essential to the functionality of the hardware. For certain sales made through the iTunes Store, the Company is not the primary obligor to users of the software, and third-party developers determine the selling price of their software. Therefore, the Company accounts for such sales on a net basis by recognizing only the commission it retains from each sale and including that commission in net sales in the Consolidated Statements of Operations. The portion of the sales price paid by users that is remitted by the Company to third-party developers is not reflected in the Company’s Consolidated Statement of Operations.

ii. Mac-branded accessories such as headphones, power adaptors, and backpacks sold in the Apple stores. What if the accessories are sold online?

The Company generally establishes its own pricing and retains related inventory risk, is the primary obligor in sales transactions with its customers, and assumes the credit risk for amounts billed to its customers. Accordingly, the Company generally recognizes revenue for the sale of products obtained from other companies based on the gross amount billed.

iii. iPods sold to a third-party reseller in India.

Similarly to selling mac-branded accessories, the Company generally establishes its own pricing and retains related inventory risk, is the primary obligor in sales transactions with its customers, and assumes the credit risk for amounts billed to its
customers. Accordingly, the Company generally recognizes revenue for the sale of products obtained from other companies based on the gross amount billed.

iv. **Revenue from gift cards**

The Company sells gift cards and records deferred revenue upon the sale of the card, which is relieved upon redemption of the card by the customer.
Honor Statement

“On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this thesis.”