A Review of Financial Statements and their Elements

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A REVIEW OF FINANCIAL STATEMENTS AND THEIR ELEMENTS

By
Anthony Gabrie Mansoor

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

________________________

Dean W. Mark Wilder
ABSTRACT
ANTHONY GABRIE MANSOOR: A Review of Financial Statements and Their Elements
(Under the direction of Dr. Victoria Dickinson)

In this thesis, I investigate various issues related to the practical application of accounting procedures. These issues include both objective activities and situations that require the preparer to use significant professional judgement. This was accomplished by researching and completing a series of twelve case studies assigned by Dr. Victoria Dickinson. These case studies consisted of various financial statements issued by real companies, both domestic and foreign and covering numerous industries. While analyzing these financial statements, I was presented with the task of researching and discussing various issues, such as appropriate disclosures of Provision of Bad Debts and Depreciation Expense. When preparing or auditing financial statements of a company, it is important to remember how many people rely on the information being accurate. Investors and creditors make crucial financial decisions based on this information, so it is critical that the statements are prepared to the best of the accountant’s ability. By analyzing some of these real world issues, I learned about the proper way to approach these figures that require profession judgement. Further, by including various industries and foreign companies, I was exposed to a healthy background of variety that I will likely encounter throughout my career.

Typically, each case had a central theme regarding a certain area of the financial statements. For example, while studying Molson Coors Brewing company, I investigated the proper way of recording different categories of gains and losses that are not considered central operating activities. Other cases focused on how to properly estimate Bad Debt Expense for a period, how to account for outstanding debt, and many other topics. Overall, the issues I encountered through my research are practical situations that
I will encounter throughout my career, and through this thesis I have been provided skills that will aid in making proper decisions in subjective issues.
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<td>Eads Heaters Income Statement</td>
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<td>Eads Heaters Balance Sheet</td>
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<td>Dividends Comparison Table</td>
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Case Study 1

Home Heaters, Inc.

Brie Mansoor

September 6, 2017

Dr. Dickinson’s Accy 420
Introduction to Home Heaters, Inc.

For the case study Home Heaters, Inc., we analyzed the transactions of two companies. These companies, Glenwood Heating, Inc. and Eads Heaters, Inc., recorded the same transactions during the course of their first year of business but differed in strategies during adjusting entries at the end of the year. For the adjustments, we were given the different methods each company preferred as well as estimates for accounts such as depreciation and bad debts. The impact these different adjustments made is clearly seen on the financial statements created for each company. For example, Eads had a higher total assets value mainly due to its decision to capitalize leased equipment rather than expense it. Glenwood, however, reported a higher net income due to the methods it used to calculate cost of goods sold, depreciation expense, and other accounts.

This case demonstrated how small differences in accounting methods, even with almost identical companies, can result in very different values on a given financial statement. This showed me the importance of the decisions companies make on how to report their financial information. Using one method over another can significantly affect certain areas of a financial statement to make the company look more or less profitable. Based on the decisions we observed, I would rather invest in Eads Heaters. I believe it was better for them to capitalize the leased equipment rather than expense it every year, and I preferred how they were conservative in estimating bad debts, depreciation, and cost of goods sold. Because they estimated these numbers to be significantly higher than Glenwood did, the net income and retained earnings should balance out over time because Glenwood might actually be accruing more expenses than it is estimating.
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</tbody>
</table>
# Eads Heaters, Inc

## Income Statement

**Year Ended Dec 31, 20X1**

<table>
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<tr>
<th>Dr.</th>
<th>Cr.</th>
</tr>
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<tbody>
<tr>
<td>Sales</td>
<td></td>
</tr>
<tr>
<td>Sales Revenue</td>
<td>$398,500.00</td>
</tr>
<tr>
<td>Net</td>
<td>$398,500.00</td>
</tr>
<tr>
<td>CGS</td>
<td>$188,800.00</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>$209,700.00</td>
</tr>
<tr>
<td>Operating Expenses</td>
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<tr>
<td>Bad Debts Expense</td>
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<td>Depreciation Expense</td>
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## Statement of Retained Earnings

**Year Ended Dec 31, 20X1**

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# Eads Heaters, Inc
## Balance Sheet
### Dec 31, 20X1

### Assets
#### Current Assets
- **Cash**: $7,835.00
- **Inventory**: $51,000.00
- **Accounts Receivable**: $99,400.00
- **Less Allowance for DA**: -$4,970.00
  - Total **Allowance for DA**: $153,265.00

#### Long Term Assets
- **Equipment**: $80,000.00
- **Building**: $350,000.00
- **Land**: $70,000.00
- **Leased Equipment**: $92,000.00
  - Total **Leased Equipment**: $592,000.00

#### Less Acc Depreciation
- **Equipment**: $20,000.00
- **Building**: $10,000.00
- **Leased Equipment**: $11,500.00
  - Total **Less Acc Depreciation**: $592,000.00

### Total Assets
- **Total Assets**: $703,765.00

### Liabilities
#### Currents Liabilities
- **Note Payable**: $380,000.00
- **Accounts Payable**: $26,440.00
- **Interest Payable**: $6,650.00
  - Total **Currents Liabilities**: $413,090.00

#### Long Term Liabilities
- **Lease Payable**: $83,360.00
  - **Total Liabilities**: $496,450.00

### Equity
- **Common Stock**: $160,000.00
- **Retained Earnings**: $47,315.00
  - Total **Equity**: $207,315.00

### Total Liabilities and Equity
- **Total Liabilities and Equity**: $703,765.00
Footnotes

- Will accrue interest of 8% on Lease payable for equipment.
- Paid off $8,640 on Lease payable principle during period.
- $16,000 is due at year end annually for equipment.
- Period of the loan for the leased equipment is 8 years.
- Cost of inventory varied and LIFO method was used to calculate CGS.
- Allowance for DA is based on assumption of 5% uncollectable receivables.
Case Study 2

Molson Coors Brewing Company

Brie Mansoor

Dr. Dickinson’s Accy 420

9/20/2017
A. The revenues section is listed first and shows any revenues the company made from regular business operations.

• If the company sells goods, rather than services, cost of goods sold is subtracted from revenues to obtain gross profit. Cost of goods sold includes any direct costs that went into obtaining the inventory sold.

• Next, operating expenses are subtracted from gross profit to find the company’s income from operations. Expenses include any costs related to the company’s regular operations.

• Other gains and losses are then added to show any irregular revenues or expenses incurred over the period. These include anything not related to the regular operations of a company, such as selling old equipment.

• Once these are accounted for, net income is calculated.

B. Classified income statements provide further details in to how the company determined net income. This helps potential investors “predict the amounts, timing, and uncertainty of future cash flows”. Classified income statements, for example show whether revenues during a period were from regular operations rather than a random gain.

C. It shows that there is less risk in investing in a company. If the company shows persistent income, the investor can easier determine when he or she will see a return on the investment.
D. “Comprehensive income includes all changes in equity during a period except those resulting from distributions to owners”. This differs from net income, as net income recognizes the change in value resulting from these distributions. Comprehensive income helps to show how profitable the company was before distributions, as these may be significantly higher in certain years.

E. Sales shows the gross overall value of the products sold. Net sales includes certain deductions that show the difference in the value of the inventory sold and what the company actually received or what it is owed. For example, if a sales discount is given on a particular sale, it will be deducted from the gross sales to show the actual value the company is receiving. Molson Coors shows these differently in order to display the value of the gross sales they will actually receive. They are required to pay excise taxes, taxes paid when certain goods are purchased. Because they must pay these on their sales, the amount of value they end up bringing in is lowered.

F. Generally, they will include any significant loss or source of income that is not expected to be reoccurring. For example, Moors sold their share of an unsuccessful venture, bringing in significant income. This income, however, is not related to regular business activities and will, therefore, not likely be repeated. The company separates these “special items” because they are not expected gains or losses, so listing it separately helps clarify the company’s performance. I do not
agree with the classification of special items as operating expenses, since they are separate from the company’s regular operations. They should be reported under “other gains and losses”.

G. Although also not a part of regular operations, “Other income(expense)” includes results from more typical transactions. While they are not regular expenses, they might occur more frequently than special items.

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

J. The effective tax rate is calculated by dividing the company’s income tax expense of $84 million by its pre-tax income of $654.5 million (both found in income statement), yielding 12.8 percent. This rate is lowered from the base of 35 percent Federal income tax mainly because the company was able to strategically take advantage of foreign tax rates.
Case Study 3

*Pearson plc*

Brie Mansoor

October 4, 2017

Dr. Dickinson’s Accy 420
Pearson plc - Accounts Receivable

For this case, we analyzed data related to the receivables of Pearson Plc and the changes in them. The main accounts we practiced with were ‘the provision for bad and doubtful debts’ (allowance for doubtful accounts) and ‘the provision for sales returns’ (allowance for sales returns). The company estimates these accounts at the end of each period. They must do this so the expenses related to the sales of the period are correctly reflected on the income statement. Once given the estimates, we analyzed the financial data in order to find relevant amounts and changes in those amounts. With this information, we were able to create T accounts and journal entries related to accounts receivables, bad debts expense, and sales returns.

These exercises helped me understand exactly when these accounts are estimated and written off. The case made me understand what activities affect accounts receivable and when. For example, bad debts expense is estimated at the end of a period, but does not affect accounts receivable until the debt is officially written off. Companies must do this because the receivables that might become uncollectable have to be shown as an expense related to the sales of that period. This results in more reliability and consistent financial data. Overall, this case study made it clearer when companies recognize estimated expenses related to receivables and why.
A. Value the seller is owed from a previously completed sale or service done, which is expected to be collected within the next accounting period. It can also be called trade receivables.

B. Accounts receivable result from a transaction of a product or service in the ordinary course of business, while notes receivable result from the lending of money or other types of credit extensions not directly involved in the course of business. Further, Accounts receivable typically do not incur interest while notes receivable do.

C. A contra account is an account with a balance opposite of the account it directly affects. “Provision for bad and doubtful debts” (Allowance for doubtful accounts) and “provision for sales returns” (Allowance for sales returns and allowances) affect Pearson’s receivables. Allowance for doubtful accounts estimates the value of current receivables that will be uncollectable due to the customer not paying. At the end of a period, managers will estimate this provision based on historical outcomes and current customers. Allowance for sales returns and allowances attempts to estimate the value of inventory, sold in the current period, that will be returned in the following period. Managers must do this because if goods are returned, then the company can no longer recognize the related receivable, and therefore, assets would be overstated on the balance sheet. Similarly, they will base this estimate on historical performance and unique factors.
D. The percentage of sales method includes taking the amount of either total or credit sales and multiplying it by a percentage to estimate uncollectable debt. The aging of accounts procedure is more complex. Under this method, the company separates its receivables based on if and how long a receivable is overdue. It estimates percentages of the receivables in each of these different time frames that will be uncollectable. The longer a debt is outstanding, the less likely it is to be collected. For this method, the managers need more information about the receivables account, including how much is owed by the individual customer, when the payment was due, and how much, if any, has been collected. For the percent of sales method, however, the manager only needs the total sales or total credit sales and the percent expected to be uncollectable. The aging of accounts method is likely to be more accurate since it provides a more detailed estimate of uncollectable

E. While there is risk that some customers will fail on their obligation to pay, it is more than likely a small percentage of the company’s total sales. The stricter the company becomes on credit requirements; the less revenue it is able to generate. Because of this risk, the managers of each company must find a tradeoff between increased revenues and riskier credit that they are comfortable with.
• Exchange differences- Transactions with these receivables allowed the company to reduce their estimate bad debts by 5 million. These receivables might have been sold to a collection agency.

• Income statement movements- Current period transactions carried an estimated 26 million in bad debts

• Utilized- The company wrote of 20 million in bad debts

• Acquisition through business combination- by taking on the responsibilities of another business, the company increased its provision for bad accounts by 3 million in relation to the receivables of the acquired company.
Provision for Bad and Doubtful Debts 5

Accounts Receivable 5

Bad Debts Expense 26

Provision for Bad and Doubtful Debts 26

Provision for Bad and Doubtful Debts 20

Accounts Receivable 20

Accounts Receivable 3

Provision for Bad and Doubtful Debts 3

iii. Bad Debts expense is recorded under operating expenses.

G. i.
<table>
<thead>
<tr>
<th>Allowance for Sales Returns and Allowances</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>372,000,000</td>
</tr>
<tr>
<td>425,000,000</td>
</tr>
<tr>
<td>--------------------------------------------</td>
</tr>
<tr>
<td>Estimated Returns</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>443,000,000</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Actual Returns</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>443,000,000</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Ending Balance</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>354,000,000</td>
</tr>
</tbody>
</table>

ii.

Sales Returns 425,000,000 (Income Statement)

Allowance for Sales Returns 425,000,000 (Balance Sheet)

Allowance for Sales Returns 443,000,000 (Balance Sheet)

Accounts Receivable 443,000,000 (Balance Sheet)

iii.

The estimated sales returns will be subtracted out of the sales item line under revenues.
H.

Gross Accounts Receivable (Millions)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning Balance</td>
<td>1414</td>
<td></td>
</tr>
<tr>
<td>Gross Credit Sales</td>
<td>5978</td>
<td></td>
</tr>
<tr>
<td></td>
<td>443</td>
<td>sales returns</td>
</tr>
<tr>
<td></td>
<td>5198</td>
<td>Cash collections</td>
</tr>
<tr>
<td></td>
<td>391</td>
<td>Write-offs</td>
</tr>
<tr>
<td>Ending Balance</td>
<td>1360</td>
<td></td>
</tr>
</tbody>
</table>

Accounts Receivable 5978

Sales 5978

Sales Returns & Allowances 443

Accounts Receivable 443

Cash 5198

Accounts Receivable 5198
Bad Debts Expense 391

Accounts Receivable 391
Case Study 4

Palfinger

Brie Mansoor

Dr. Dickinson’s Accy 420

11/8/17
Palfinger

In this case, we observed various methods to treat equipment accounts. We were able to see in the financial reports details pertaining to how the company values and records its equipment on the balance sheet, including different categories it assigns to different types of equipment. We also looked at how a company can choose to capitalize on interest of assets under construction. In this case, the company included the interest expense into the cost of the building of the assets. As recently learned in Intermediate, the company must record this at the lower value of actual interest incurred or avoidable interest. A company could choose to record the interest during this time as an expense, but that would not make much sense. Similarly, this case showed that companies can add to the existing value of its equipment through value enhancing renovation. Like the interest under construction, the company could also expense these if it chose, but capitalizing the way Palfinger does adds to the overall value of the asset. We also observed how Palfinger records depreciation on its equipment. There are several ways to do this, but they chose to use straight line depreciation, in which the depreciation expense is the same throughout every depreciable period.

The case showed how much of an impact decisions related to property, plant, and equipment accounts can make on the financial statements. Choosing to capitalize on various costs adds to the value of the asset and would not affect the income statement, while expensing them would. Depreciation method makes a large difference in how the assets are valued as seen in ‘g-j’. Choosing straight line over double declining resulted in far less depreciation over the first period, which created smaller effects in the income statements during the example.
A. Since the description includes that the company is a manufacturer of heavy machinery and various construction equipment, property and equipment will probably include heavy duty tools and machinery. This would include items such as forklifts, welding equipment, and factory type machinery. Items in this category would not typically be held for resale.

B. The 149,990 of PPE on the balance sheet represents the total value less depreciation of all of the company’s assets that are classified as property, plant, and equipment. These will be long term, relatively expensive items that are durable enough to be used and depreciated over several periods. They will continue to depreciate until they reach a salvage value, then will be disposed of.

C. They report that their PPE includes buildings the company owns, buildings they are invested in, plant and machinery, and fixtures, fittings, and equipment. Besides buildings, these categories are broad. Plant and machinery would likely include very large, factory type equipment while fixture would include smaller items such as power tools.

D. This account represents assets that the company is producing under its direct management. This means that it has to be built by the company and not bought from a third party. This account will include costs such as labor and overhead attributed to the production of the asset. This account does not show depreciation because the company chooses to capitalize on the cost of this depreciation rather than record the cost. The company states a reclassification of this account of (14,958) during 2007. Because it is
negative, it represents a loss association with the construction of these assets. This means that the sum of all of the value transactions that went in to the construction of the asset ending up being more expensive than if the company were to directly buy it from a third party. The company “over paid” for this asset and must show the loss.

E. Palfinger uses straight line depreciation, so it uses the assumption the equipment loses the same amount of value each period. This seems reasonable because they should be able to estimate the useful life accurately because they know to an extent how long the equipment will last based on how much they expect to produce. This does present a tradeoff though. They could record depreciation more accurately if it was calculated based directly on factors such as how many hours the equipment was in use. This would be more accurate as the depreciation would rise if the equipment is being used more but would likely be very time consuming. Overall, straight line depreciation is probably fine for the company to use in this situation.

F. These expenditures are “capitalized and depreciated over either the new or the original useful life.” They then recalculate depreciation based on the added value. This means the company basically adds these transactions to the overall value of the assets. This way, the company can capitalize on the expenditures as a cost since they are recording them as additional value to an asset. The alternative would be to record these expenditures as expenses. Since these are large expenditures, this would probably not be favorable to the company. This would be a very large, irregular expense that would negatively affect net
income for the period. By not recording this expense, the company is most likely providing more consistent, relevant financial statements.

G.

i. 61,444

ii. 733 These types of grants are “recognized in profit or loss on a systematic basis over the periods in which the entity recognizes expenses for the related costs for which the grants are intended to compensate, which in the case of grants related to assets requires setting up the grant as deferred income or deducting it from the carrying amount of the asset.” The grants are deducted from the value of the asset since the company was compensated this amount in the cost of the asset. This is similar to, when buying inventory, if it is purchased at a discount the company must record the inventory at the cost it actually paid for it. Since the company was not responsible for this 733, it should not capitalize it as value to the asset. Alternatively, the company could show the effect of this grant in the income statement as a loss or gain.

iii. 12,557
iv. 1,501 To find the net book value disposed of, we must take the total asset disposed (13,799) and subtract the effect of the depreciation associated with the disposal (12,298).

H. Since the equipment had a book value of 1,501 and the company received 1,655 in cash, they experienced a gain of 154. This number is the “plug” in the entry that would include debiting cash and accumulated depreciation then crediting equipment and a gain for the difference. Economically, this means that the company received 154 more than what it believed the asset was worth.

I. i. Straight line

<table>
<thead>
<tr>
<th>Year</th>
<th>Carrying value</th>
<th>Depreciation Expense</th>
<th>Accumulated Depreciation</th>
<th>Book Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>10,673</td>
<td>1,880</td>
<td>1,880</td>
<td>8,793</td>
</tr>
<tr>
<td>2008</td>
<td>8,793</td>
<td>1,880</td>
<td>3,760</td>
<td>6,913</td>
</tr>
<tr>
<td>2009</td>
<td>6,913</td>
<td>1,880</td>
<td>5,640</td>
<td>5,033</td>
</tr>
<tr>
<td>2010</td>
<td>5,033</td>
<td>1,880</td>
<td>7,520</td>
<td>3,153</td>
</tr>
<tr>
<td>2011</td>
<td>3,153</td>
<td>1,880</td>
<td>9,400</td>
<td>1,273</td>
</tr>
</tbody>
</table>
ii. Double declining

<table>
<thead>
<tr>
<th>Year</th>
<th>Carrying value</th>
<th>Depreciation Expense (40%)</th>
<th>Accumulated Depreciation</th>
<th>Book Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>10,673</td>
<td>4269</td>
<td>4269</td>
<td>6404</td>
</tr>
<tr>
<td>2008</td>
<td>6404</td>
<td>2562</td>
<td>6831</td>
<td>3842</td>
</tr>
<tr>
<td>2009</td>
<td>3842</td>
<td>1537</td>
<td>8368</td>
<td>2305</td>
</tr>
<tr>
<td>2010</td>
<td>2305</td>
<td>922</td>
<td>9290</td>
<td>1383</td>
</tr>
<tr>
<td>2011</td>
<td>1383</td>
<td>110</td>
<td>9400</td>
<td>830</td>
</tr>
</tbody>
</table>

J.

i. Under straight line, the equipment would incur one year of depreciation expense at 1,880 per year. This would make the carrying value 8,793 on the date of the sale. The sale transaction would include a debit to cash of 7,500 and accumulated depreciation of 1,880, then, credits to equipment for 10,673. The final credit would be the plug number, resulting in a loss of 1,293. For 2007, the asset affected the income statement through the depreciation expense. For 2008, the company recognized a loss on the income statement and no depreciation expense was recorded related to this asset.

ii. Under double declining, the equipment would incur 4,269 of interest expense during the first year, leaving the carrying value at 6,404 on the date of the sale. The sale would result in debits to accumulated depreciation [4,269] and cash [7,500] and credits to equipment [10,673] and gain on sale [1,096]. The effects on the income statements would
be the depreciation expense during 2007, lowering net income and the gain during 2008, raising net income.

iii. Since double declining depreciation is based on the carrying value of the equipment in the given period, it is usually significantly higher during the first depreciable period. Because of this, the company would have to incur a lot more depreciation expense in 2007 under double declining but would record a significantly higher gain during 2008. This happens because the company would be valuing the equipment at a lower value than under straight line after the first year. Because of this, the exchange of the same amount of cash results in a much higher gain under double declining. This higher gain works to offset the increased depreciation expense, resulting in both methods provided a net decrease to net income of (3,173) over two years.
Case Study 5

Volvo

Brie Mansoor

Dr. Dickinson’s Accy 420

11/22/2017
Volvo Case

In this case, we looked at intangible assets, specifically research and development costs. Volvo, because it is a Swedish company, is allowed to capitalize certain research and development costs as assets rather than expensing them. The criteria for which and how much of these costs to expense was the main focus of this case. Under IAS 38, Volvo can capitalize research and development costs if the product can be shown to promise success before it is launched. They must also be able to accurately match these costs to each project. This can create inconsistencies as it is difficult to accurately predict the future success/benefits of a product and match the costs to each product. We observed changes in financial statements to research how Volvo accounted for these costs over the course of several years. It showed a steady increase, and when compared to Navistar it was evident that these increases were relatively large.

While it makes sense for the research and development costs for a successful product to be capitalized since they are a direct product cost, I believe the Swedish method is not effective. US GAAP allows for some development costs to be capitalized, only if it is certain the product will be successful. I believe this method is better because it is impossible to perfectly predict a product’s future and match costs to the product. This can lead to misstated financial statements which will have a negative impact on investors.
A. This is an operating expense on the income statement that likely includes costs related to wages specific to employees or third party members, as well as the resources they use, focusing on the implementation of a new product or expansion of an existing product line. Examples would include research and testing of new safety features for Volvo’s cars.

B. A portion of these expenses may be capitalized as an asset if the new product can be proven functional prior to development. To do this there must be a high degree of certainty that the expense will provide future benefits, so Volvo considers the probability of the product’s success. They must also be able to distinguish reasonably the costs that went directly into the production of the product. If these conditions are not met, the costs will be recorded as an operating expense and deducted from net income.

C. The company would determine how long they expect to receive financial benefits directly from the capitalized expenses. The amount of time they determine will be the asset’s useful life. They then divide the cost by this time frame to find the yearly amortization expense under the straight line assumption. Since this asset is intangible, it will most likely not have a salvage value, so when it cannot provide further benefits its value is zero.
D. I think that generally the US GAAP provides more accurate financial statements in regards to R&D expenses. This is because it is difficult to determine the exact costs that went in to each product and if it will be successful, providing future benefit. Because this is so hard to determine, it is difficult to match expenses to revenues if the asset is capitalized. Also, if the product ends up being unsuccessful, prior income statements and balance sheets will be overstated.

E. i. 11,409 This is listed as carrying value on the financial statements and represents the total amount of capitalized expenditures less accumulated amortization. This represents how much value the asset has left.

<table>
<thead>
<tr>
<th>Product and Software Development</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beg Balance(net)</td>
</tr>
<tr>
<td>Amounts Capitalized</td>
</tr>
<tr>
<td>Amortization</td>
</tr>
<tr>
<td>Less: Plug</td>
</tr>
<tr>
<td>End Balance(net)</td>
</tr>
</tbody>
</table>

ii.

F. i.

<table>
<thead>
<tr>
<th>Product and software development costs capitalized during the year</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total R&amp;D expense on I/S</td>
<td>11,059</td>
<td>14,348</td>
<td>13,193</td>
</tr>
</tbody>
</table>
Amortization of previously capitalized costs  2,357  2,864  3,126
Total R&D costs incurred during the year  10,759  13,634  12,669

iii. in 2007 they capitalized 2057/10759 total R&D= 19.12%
     2008: 2150/13634= 15.77%
     2009: 2602/12669= 20.54%

G. i.

<table>
<thead>
<tr>
<th>SEK</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>294,932</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.

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Navistar</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total R&amp;D</td>
<td>375</td>
<td>384</td>
<td>433</td>
</tr>
<tr>
<td>Net Sales</td>
<td>11,910</td>
<td>14,399</td>
<td>11,300</td>
</tr>
<tr>
<td>R&amp;D/Net Sales</td>
<td>3.15%</td>
<td>2.67%</td>
<td>3.83%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Volvo</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total R&amp;D</td>
<td>10,759</td>
<td>13,634</td>
<td>12,669</td>
</tr>
<tr>
<td>Net Sales</td>
<td>276,795</td>
<td>294,932</td>
<td>208,487</td>
</tr>
<tr>
<td>R&amp;D/Net Sales</td>
<td>3.89%</td>
<td>4.62%</td>
<td>6.08%</td>
</tr>
</tbody>
</table>

Volvo increased their R&D expenses every year proportionally while Navistar stayed in the same general range. Volvo’s percentage was higher than Navistar’s
each year, and continued to increase by 1-2% each year while Navistar stayed around 3%.
Case Study 6

Software Case: IBM Watson

Brie Mansoor

Dr. Dickinson’s Accy 420

1/31/2018
IBM Watson

In this case, each group was given a software to research, specifically, how this software will impact accounting. My group researched IBM’s Watson. Watson is probably the most advanced form of artificial intelligence on the open market today. It is able to process huge amounts of data instantaneously and recall this data at any given time. This can be seen by its winning of Jeopardy several years ago. During this, Watson was not even connected to the internet but was able to recall data that it had seen before.

These abilities will surely have a huge impact on the accounting industry. The big four have already began working with Watson, trying to “fine tune” its abilities into what they need. Watson will be able to analyze data much faster than a person could which will significantly reduce the time it takes to perform audits, prepare financial statements, and more. Because it is able to do so much, it seems worrisome that it could begin to replace CPAs. I obviously do not think it will completely replace accountants, but because it is so much more efficient at going through large amounts of data, I believe it could lower the demand for accountants to some degree (especially entry level). Despite this, I think Watson will be good for the industry as it will make processes more efficient and save clients’ money.
Watson is an Artificial Intelligence systems which is able to answer a wide variety of questions in natural language.

Publicly proven successful when it won jeopardy without being connected to the internet 2011.

Capable of answering questions as people would normally ask them, so the user does not need to put the questions into code to get an accurate response.

According to IBM’s website, Watson can “Accelerate research and development, enrich your interactions, anticipate and preempt disruptions, recommend with confidence, scale expertise and learning, and detect liabilities and mitigate risk.”

Can use data to personalize customers’ needs and desires, allowing for companies to specify their products.

Analyzes data in order to predict potential risks in a business before they happen.

“Uses IBM’s Deep QA software and the Apache UIMA (Unstructured Information Management Architecture) framework.”

Ran by powerful processors than can gather and analyze huge quantities of data.

When a question is asked, it analyzes keywords and finds which answer will statistically be the most accurate.

What makes it unique is its ability to run hundreds of algorithms instantaneously.

Generally, whichever answer is found by the most algorithms will be the answer Watson chooses.

Pulls data from a variety of sources such as journals, newspapers, and books
2.  
- Because Watson is so expensive, a company must have significant funds on hand in order to implement it.
- After implementation, the users need to make sure the hardware is consistently running properly and be able to respond to the information that is given by Watson.
- There is not much needed to be done to actually ask a question; the majority of skill needed relates to the maintaining of hardware.
- To fully utilize this, a student could have background in computer engineering and also have a good understanding of how the business works so that they are able to implement proper responses.

3.  a. Auditing
- Users can feed Watson all of the company’s financial information. Then Watson can “Wade through miles of corporate jargon, saving time and resources.” Watson will be able to make auditing easier and faster by being able to filter through the data almost instantaneously.
- Watson could memorize and instantly recall every audit standard and other various laws or regulations. This will also speed up the auditing process since a CPA will not have to refer as often to the internet or written standards to check for relevant regulations.
- KPMG is currently trying to have employees “teach” Watson how to make assessments over all kinds of data related to a company in order to make more human-like decisions on what is relevant information. Auditors could use this to filter out what they actually need to perform the audit. This would help auditors be able to “identify anomalies and determine which steps to take as a result.”

b. Tax Planning

- Watson would be able to memorize the thousands of pages of tax code, which would be almost impossible for a person to do. Because of this, it will be able to find the best accounting method to use for a given situation in order to save the client money.

- Watson could analyze past successful accounting techniques used with the current client or other clients in order to apply a method that has been proven to work for different problems.

- Since the software is already “being used to analyze contracts and other business documents,” it would make sense to run a rough draft of the prepared tax documents through Watson. It could then make sure the methods used are in line with current standards in order to protect the client and the firm from potential trouble.

c. Financial Analysis
• Watson would be capable of continuously analyzing a client’s current portfolio, determining which investments are currently doing well and which are not. The client would then be able to easily identify if it wants to increase its investment in certain stocks or sell others.

• By analyzing data not only from a client’s portfolio but the open market, Watson could help to predict which stocks are going to begin to rise quickly and which will crash. One of the main selling points of Watson is its ability to “predict problems before they happen,” so this seems like it would work well.

• To increase accuracy of financial advisory, Watson could run simulations of various business plans and investments to determine the probability of its success. This will help clients make decisions before undertaking risky ventures.

4.

Watson has shown innovation in artificial intelligence at its highest level. It has already begun to transform markets such as healthcare. If we do not invest in this technology soon, our competitors will and we will be left behind and begin to lose clients. We simply will not be able to keep up with the speed and efficiency of our competitors if they have this technology that we lack.

Watson will make an impact on nearly every aspect of our business. Its ability to process vast amounts of data will significantly speed up the audit process, and its ability
to recall this data will provide more accurate tax information. It will also be able to better predict the success or failure of various businesses and investments. Additionally, all of this will be done by saving time and resources since we will have less employees required for many tasks.

Sources:

https://www.ibm.com/watson/about/index.html

https://en.wikipedia.org/wiki/Watson_(computer)

Case Study 7

Rite Aid

Brie Mansoor

Dr. Dickinson’s Accy 420

2/14/18
Rite Aid Case

In this case, we focused on various debts held by Rite Aid in 2010. Depending on the circumstances when the debt was issued, the specifics varied. For example, some were issued at discounts and some were issued at par. The interest rates also varied, most likely depending on the time they were issued. A main focus of this case was how different debts are collateralized. Secured debts are backed by assets, which the lender owns a claim to if the borrower is unable to pay debts. This reduces the risk for the lender. Unsecured debts are not backed by assets, so if the borrower is unable to pay the lender would have to make a legal claim on value of the business. Guaranteed debt is backed by a promise of another entity to pay the debt if the borrower is unable, which again reduces risk for the lender. The case showed how one company may have a wide variety of these different types of debt in order to finance growth.

The main thing I learned from this case is about the different categories of debt. Issuing debt under these different categories can help create more favorable terms. If the lender is issued a senior, secured, or guaranteed debt, they are probably not as worried about getting their investment back since they know they are a priority creditor or that their investment is collateralized.
a.

i. The secured debts are backed by assets as collateral, while unsecured are not. Disclosing this is important as each type of debts presents different liabilities. If the company has too much of either, it could be vulnerable to claims on assets or ownership from creditors.

ii. Much like a car dealership requiring you to have someone sign as a guarantor on your loan, guaranteed debt is backed by a binding promise from a different company to pay the debt if the borrower is unable. Rather than a completely different company, these debts are backed by subsidiaries.

iii. Senior debt has priority over others and will be paid first. Fixed rate charges an interest rate that stays the same over the life of the debt. Convertible debt allows the option for the lender to receive shares of stock in repayment of the debt. The amount is usually determined before issuance.

iv. They most likely needed more cash on hand during certain times which would lead to the company taking on different types of debt. Interest rates change over time, so taking out loans at different times would explain the various rates.

b. According to note 11, Rite aid has a total debt balance of 6,370,899. This consists of 51,502 in current debt and 133,764 in a lease obligation, which would both be due in
the following year. This differs from the “liabilities” section on the balance sheet because the balance sheet includes payables that are not classified as debt in the way that notes and bonds are. These extra accounts, such as accounts payable and accrued liabilities, are part of the everyday operations of the company and do not involve financing through debt.

c.

i. Although not stated as the other face values are, the value of this note is assumed to be 500,000 because the carrying value did not change over the previous year. It was probably issued at par.

ii. Cash 500,000

     Notes Payable 500,000

iii. Interest Expense 37,500

     Cash 37,500

iv. Notes Payable 500,000

     Cash 500,000
d.

i. The face value equals 410,000 and the carrying value equals the face value minus and unamortized discount. \(410,000 - 4,049 = 405,951\)

The difference is that the bonds are originally sold below par value, and this discount is amortized over the life of the bond through interest expense until it reaches face value at maturity.

ii. They paid the stated rate of the principle, or 9.375% of 410,000 which equals 38,438.

iii. The total interest expense for this debt equals the cash paid plus the discount that was amortized over the period--- \(38,438 + 705 = 39,143\)

iv. Interest Expense 39,143

<table>
<thead>
<tr>
<th>Discount</th>
<th>705</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>38,438</td>
</tr>
</tbody>
</table>

v. The total rate of interest expense, or effective rate, equals interest expense divided by beginning of period CV. \(39,143 \div (410,000 - 4754) = 9.655\%\)

e.

i. Proceeds(Cash) = 98.2\% \times 410,000 = 402,620
Cash 402,620
Discount 7,380
Notes Payable 410,000

ii. Divide interest expense (40,750) by beginning of period carrying value (402,620) to get 10.12%

iii.

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash out</th>
<th>Int Exp</th>
<th>Amortized</th>
<th>CV</th>
</tr>
</thead>
<tbody>
<tr>
<td>6/30/09</td>
<td></td>
<td></td>
<td></td>
<td>402,620</td>
</tr>
<tr>
<td>6/30/10</td>
<td>39,975</td>
<td>40749.98</td>
<td>774.98</td>
<td>403394.98</td>
</tr>
<tr>
<td>6/30/11</td>
<td>39,975</td>
<td>40828.41</td>
<td>853.41</td>
<td>404248.39</td>
</tr>
<tr>
<td>6/30/12</td>
<td>39,975</td>
<td>40914.79</td>
<td>939.79</td>
<td>405188.18</td>
</tr>
<tr>
<td>6/30/13</td>
<td>39,975</td>
<td>41009.91</td>
<td>1034.91</td>
<td>406223.08</td>
</tr>
<tr>
<td>6/30/14</td>
<td>39,975</td>
<td>41114.65</td>
<td>1139.65</td>
<td>407362.73</td>
</tr>
<tr>
<td>6/30/15</td>
<td>39,975</td>
<td>41230.00</td>
<td>1255.00</td>
<td>408617.73</td>
</tr>
<tr>
<td>6/30/16</td>
<td>39,975</td>
<td>41357.02</td>
<td>1382.02</td>
<td>409999.75</td>
</tr>
</tbody>
</table>

iv. Interest Expense 27,167
Discount 517
Interest Pay 26,650

v. The new book value equals beginning carrying value plus the amount of discount amortized.

402,620 + 517 = 403,1
Case Study 8

“Taxodus” Documentary

Brie Mansoor

Dr. Dickinson’s Accy 420

3/21/18
The documentary “Taxodus” focuses on how large corporations and wealthy individuals avoid taxes. First, it explained how Apple receives its tremendous margins. Cheap foreign labor and revenue flow allows the company to drastically increase its profit. It is able to produce iPads for $40 each in China, leading to margins around $6 billion. By then funneling these profits through various countries including the Netherlands and Ireland, Apple is able to pay 1.9% corporate tax. Compared to the United States corporate tax rate of 35%, the difference is drastic. Many more of the world’s largest companies are also attracted to the Netherlands as it has the most tax treaties in the world. Another the documentary mentioned is Wal-Mart. Wal-Mart has six entities in the Netherlands, but it has no operations in the country. Because of this and the unusually names such as “Blue Leaf,” it is pretty obvious to see that they are doing this for fiscal reasons, specially to avoid taxes.

The documentary also described similar situations in Africa. Developing countries will provide large corporations with a 10-year tax holiday once established, meaning the company will not pay any corporate income tax at all. The countries are motivated to do this because they believe bringing these big businesses will help stimulate the poor economies. The video, however, argues that this is not necessary because the main reason these companies go there is for the natural resources which cannot be moved, so the companies would have to come there anyway. Once the tax holiday is over, the business can simply leave or change ownership, which extends the holiday. These circumstances have been so effective at attracting these large corporations that certain “safe zones” exist in these areas that are almost like a separate, exclusive city inside the country. These zones may even have laws specific to them. An example used in the video is that studios
such as NBC might have the right to free speech while in the building, but once someone walks outside they lose that right. Also, because these zones are often guarded and off-limits to the public, it makes it very difficult for the common person to find a job there.

I found the premise this documentary very interesting. The idea of how corporations are able to reduce taxes is intriguing, but the video was very one sided and anti-big business. The video constantly pointed to the idea that there is a thin line between smart and illegal. While I think that certainly some of what these companies are doing is wrong, I would like to hear the other perspective. It is explained how it takes a large group of people to orchestrate these deals including accountants, bankers, and lawyers (or the “pinstripe mafia). I think it would be interesting to hear some of these professionals from the other side talk about the subject since, from the business’s prospective, these tax deals are very beneficial. To me, if the company is not violating any laws, then they are simply optimizing the returns of the business. However, I understand that there may be a grey area between what is illegal and what is not, so it comes down to the individual judgment and ethics of the individual to choose to partake in these strategies or not.
Case Study 9

*Merck*

Brie Mansoor

Dr. Dickinson’s Accy 420

2/23/2018
Merck Case

In this case, we focused on stockholder’s equity and various related accounts and transactions. The case demonstrated the effects of treasury stock on the financial statements. Purchasing treasury stock lowers the amount of shares outstanding for a company which helps show how issued, outstanding, and authorized shares are different. We saw how treasury stock works as a contra equity account, and this explained the reconciliation between the value of common stock outstanding and the number of shares outstanding. We also focused on looking through several financial statements in order to reconcile amounts such as dividends paid. We had to compare changes in the balance sheet to the statement of cash flows to determine how much of different transactions were paid in cash.

The main thing I learned from this case was that we must go through several financial statements sometimes in order to find an amount. Sometimes in order to reconcile a change in the balance sheet you must compare it to the statement of cash flows. The case helped demonstrate how these different statements are choreographed together.
a.
   i. 5,400,000,000 shares authorized for use

   ii. 2,983,508,675 issued as of 12/31/2007

   iii. The balance sheet reports common stock rounded to 29.8 million. Divide this by the shares issued to get a par value of about $0.10 per share.

   iv. 811,005,791 shares in treasury

   v. Issued-treasury shares= outstanding
      
      \[ 2,983,508,675 - 811,005,791 = 2,172,502,884 \]

   vi. outstanding shares \( \times \) 57.61 = 125,157,891,100

c. Dividends provide income to shareholders which increases the value of its stock to potential investors.

d. Most likely, a company will purchase treasury stock when it wants to reduce the number of shares outstanding. This will make ownership less diluted to current shareholders and can help to avoid situations such as a hostile takeover.
e. Retained Earnings  3,310.7

Dividends payable  3,310.7

g.
i. Merck uses the cost method for accounting for treasury stock, which values the stock at the cost the company purchased it (Market price).

ii. 26.5 million shares were purchases during 2007

iii. 1,429.7 million total / 26.5 million shares = 53.95 per share  This is a financing cash flow

iv. Treasury stock is a contra equity account as it reduces the amount of shares outstanding.
<table>
<thead>
<tr>
<th></th>
<th>Merck</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2007</td>
<td>2006</td>
</tr>
<tr>
<td>dividends paid</td>
<td>3,307.30</td>
<td>3,322.60</td>
</tr>
<tr>
<td>Shares outstanding</td>
<td>2,983,508,675</td>
<td>2,976,223,337</td>
</tr>
<tr>
<td>Net income</td>
<td>3,275.40</td>
<td>4,433.80</td>
</tr>
<tr>
<td>Total Assets</td>
<td>48,350.70</td>
<td>44,569.80</td>
</tr>
<tr>
<td>Operating Cash flows</td>
<td>6,999.20</td>
<td>6,765.20</td>
</tr>
<tr>
<td>year end price</td>
<td>57.61</td>
<td>41.94</td>
</tr>
<tr>
<td>Div/share</td>
<td>1.12</td>
<td>1.12</td>
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<tr>
<td>Div yield</td>
<td>0.02</td>
<td>0.03</td>
</tr>
<tr>
<td>Div payout</td>
<td>1.01</td>
<td>0.75</td>
</tr>
<tr>
<td>Div to total assets</td>
<td>0.07</td>
<td>0.07</td>
</tr>
<tr>
<td>Div to operating cash flows</td>
<td>0.47</td>
<td>0.49</td>
</tr>
</tbody>
</table>
Case Study 10

State Street

Brie Mansoor

Dr. Dickinson’s Accy 420

4/4/18
State Street

In this case, we observed how a financial company reports its investments in various securities, debt and equity. Debt securities can be classified as held to maturity (HTM), available for sale (AFS), and trading securities. Held to maturity means that the holder intends to keep the security until its maturity date. Since there is not a maturity date on equity investments, equity securities cannot fall under this classification. Available for sale securities are securities that the holder might want to sell, and trading securities are securities that are likely to be sold in the short term. The main difference between trading and AFS is the degree to which the owner intends to sell. These classifications are very important. How a company labels a given security determines how it is valued on the balance sheet and how changes in the value affect the financial statements. During the case, we saw that both trading securities and AFS securities are recognized at fair value and that an adjustment account is periodically updated in order to bring the security to its current fair value. They differ in that gains and losses associated with the changes in fair value are recognized as income on the income statement for trading but are recognized as unrealized holding gains in the statement of comprehensive income for AFS. HTM differ from both. These are recorded at cost, are amortized periodically, and no gains or losses are recognized from changes in fair value periodically. The decision to use one of these considerations over another has significant impacts on the financial statements of a company.
a.

i. Trading securities are debt or equity instruments that are intended to be sold in the short term. The owner’s main goal with trading securities is to make money off of capital gains or dividend/interest income.

ii. Cash 1

Interest/Dividend Revenue 1

To record revenue from trading securities

iii. Fair Value Adjustment (Trading) 1

Unrealized holding gain or loss-Income 1

To record an increase in market value

b.

i. For available for sale securities, the managers are unsure about their intent of the instrument. They classify securities as AFS if they think they may want to sell the security at some point but most likely not in the near future. Because the securities may be sold, they are recorded and updated at fair value.

ii. Cash 1

Interest/dividend revenue 1
To record revenue from AFS securities

iii. Fair Value Adjustment (AFS)  1
    UHGL-Equity  1

To record an increase in Market Value

c.

i. Held to maturity securities are debt securities that the holders tend to keep until the maturity date. During this time, the holder will collect interest revenue. Since stocks do not have a maturity date, these can only be debt securities. These securities are recorded at book value and are not updated to fair value periodically.

ii. no entry is required to record an increase in market value

d. Trading Securities:

   i. 637,000,000 is the balance on 12/31/2012, which is the fair value at the time. They are stated at fair value since they are classified as trading.

   ii. FVA (Trading)  85,000,000
       UHGL-Income  85,000,000

To record an increase in fair value
e.  Held To Maturity Securities:

   i.  12/31/2012 balance: 11,379 million  This is the historical cost of the securities.

   ii. Market value of HTM securities: 11,661 million

   iii. 11,379 million  Amortized cost the book value of the securities after any premium or discount is amortized to date. Since HTM securities are recorded at book value, this represents the balance on the balance sheet.

   iv. Since the fair value is greater than the amortized costs, the market interest rate has dropped since the HTM securities were issued. Since these are not recorded at fair value, no unrealized gain is recognized.

f.  Available for Sale Securities:

   i. 12/31/2012 balance: 109,682 million  which represents the current fair value of the securities.

   ii. 2001 gain - 882 loss=  unrealized gain of 1,119 million
iii. 101 gain - 46 loss = realized gain of 55 million. This would show up under the operating sections of the income statement and statement of cash flows since the sales of securities are a main business function of this company.

g. Investing Cash Flows:

i. To purchase AFS securities:

   Equity Investment (AFS)     60,812

   Cash                        60,812

ii. To record the sale of AFS securities:

   Cash                       5,399

   UHGL- Equity               67

   Equity Investment (AFS)    5,411

   Gain on Sale (AFS securities) 55

iii. 5,411 million represents the original cost of the AFS securities
Case Study 11

Zagg, Inc.

Brie Mansoor
Zagg Case

In this case, we focused on income taxes. Specifically, we observed how differences arise between taxable and financial income, what different interest rates mean, how companies record taxes, and how to analyze financial statements in order to find these amounts. By looking for balances and changes in amounts on Zagg Inc.’s financial statements, we were able to find how much Zagg paid in income taxes and how deferred taxes affected this. We focus on how these deferred taxes are reported and why they are so important. ASC 740 explains much of the uncertainty in this, explaining how companies must display decisions made that created a deferred tax position. This is so important since when these arise, taxes paid can materially deviate from income tax expense.

The main thing I learned from this case was the significance of reporting deferred taxes in income tax expense. I did not realize how drastically a company could change its financial position based on how it reported income taxes if it did not have to show the effects of these. Because of this necessity, financial statements better represent the standing of a company by accurately displaying the expense it actually incurred during a period.
a. Book income is the net income reported on a company’s income statement. Net income for Zagg in 2012 was $14,505. Book income differs from taxable income because certain amounts of income can be nontaxable and certain situations can lead to deferred taxes. For example, a company might collect some unearned revenue. This can be taxed as income by the IRS but cannot be recognized as income under GAAP. This will lead to a higher taxable income relative to pretax financial income and will create a deferred tax asset.

b.

i. Differences between pretax financial income and taxable income that will never change. For example, interest on municipal bonds will never be taxed.

ii. Differences that create either a deferred tax asset or a deferred tax liability. These will be either taxed or deducted in future periods. An example would be taxed unearned revenue that will be deducted in the future.

iii. Statutory rate- the rate required by law

iv. Effective rate- the rate that shows the actual relationship between income tax expense and pretax financial income

c. ASC codification 740 was passed in part to help clarify uncertainties in reporting income taxes. The codification explains that a company needs to show its current “tax position.” Choices the company makes during the period can cause the current period’s income tax to not accurately represent its tax position. Decisions such as how income or a transaction is characterized can create deferred taxes. When filing taxes with the IRS, the company will not pay the same amount of taxes as it
incurred in expense during the period. For example, a deferred tax liability will lower the amount of taxes the company pays now, and a deferred tax asset will increase the amount it pays in the current period. Because of this, companies must calculate income tax expense with consideration for these effects. In order for expense recognition to be fulfilled, income tax expense must correctly show the amount of tax expense incurred during the period. To do this, the company must evaluate how not only current period decisions will effect income taxes, but it must also look at prior period positions in order to find the gross amount of income tax expense incurred during the period. The codification states that public entities must show detailed information pertaining to the “increases and decreases in unrecognized benefits as a result of current period and prior period decisions.” These changes can help explain the differences in a company’s current income taxes payable to the IRS and the expense it incurred. If companies did not have to do this and only had to show the amount of taxes payable it had, one could use strategies to significantly alter how much taxes it pays in a current period in order to make itself look more or less profitable. For example, in order to impress investors, a company could create a deferred tax liability, thus lowering income tax and increasing net income. This would make the company look more profitable than it actually was since, although it did not have to pay a certain amount of taxes this period, the effect of these taxes are still there and will have affect in future periods. Overall, companies must include deferred taxes in income tax expense because strategic decisions will cause taxes paid and tax expense to not be the same which would lead to inaccurate financial statements.
d. Deferred tax assets and liabilities represents decisions managers make and situations that arise that cause differences between income taxes payable and income tax expense. A deferred tax asset means that a company will pay more in the current period but will save in future periods. This arises from accounting decisions that create the company’s taxable income to be greater than the financial income presented on the income statement. This leads to the company’s income taxes payable being greater than the expense incurred. Because of this, the company will have a future deductible amount in its income taxes and will pay less. For example, suppose a company receives payment in advance for an obligation it will fulfill next period. If the company recognizes a portion of this payment as earned revenue for tax purposes, which it did not do on the income statement, the taxable income will be greater than financial income, leading to higher income taxes. A deferred tax liability does the opposite. These decisions cause taxable income to be lower than financial income, creating a future taxable amount which will be paid in income taxes in future periods. For example, if a company uses a method for tax purposes which recognizes a higher depreciation expense than what is on the income statement, taxable income will be lower than financial income. This will lead to lower income tax now, but this amount will be paid in future periods.

e. A deferred income tax valuation allowance is an amount presented on the balance sheet that decreases the net value of a deferred tax object. Companies should report this when it is likely that a portion of the deferred tax object will not be realized.
f.

i. To record the income tax provision for 2012

<table>
<thead>
<tr>
<th>Date</th>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/2012</td>
<td>Income Tax Expense</td>
<td>9,393</td>
</tr>
<tr>
<td></td>
<td>DTA</td>
<td>8,293</td>
</tr>
<tr>
<td></td>
<td>Income Tax Payable</td>
<td>17,686</td>
</tr>
</tbody>
</table>

ii. This entry shows the categorical effects from the previous entry, meaning it shows the adjustments to DTA and DTL in gross amounts rather than one net amount.

<table>
<thead>
<tr>
<th>Date</th>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/2012</td>
<td>Income Tax Expense</td>
<td>9,393</td>
</tr>
<tr>
<td></td>
<td>DTA</td>
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<tr>
<td></td>
<td>DTL</td>
<td>291</td>
</tr>
<tr>
<td></td>
<td>Income Tax Payable</td>
<td>17,686</td>
</tr>
</tbody>
</table>

iii. Effective rate = \( \frac{\text{Income tax expense}}{\text{pretax financial income}} = 39.3\% \)

This difference arises from the differences between income tax expense and income taxes payable for the period.

iv. The net deferred tax asset shows up as an asset on the balance sheet. It is separated into current and non-current portions depending on when the deductible amount will be realized.
Case Study 12

Apple

Brie Mansoor
Dr. Dickinson’s Accy 420

5/2/2018
Apple Case

In this case we focused on revenues. Revenues are values received through the fulfillment of obligations related to the ongoing business processes of a company. The main different from these and any other gains is the fact that they are specific to the main business functions. We observed how companies can have trouble in estimated how much revenue to recognize and when. To add some clarity, ASC 606 was recently passed which sets five steps of revenue recognition. An entity must identify a contract, identify performance obligations, determine contract price, allocate the price to performance obligations, and recognize revenues when obligations are fulfilled. Determining when obligations can be difficult, and flexibility in this process can lead to “self-serving” revenue recognition choices. Managers can manipulate accounting methods in order to recognize revenue at the wrong amounts or wrong time.

It was interesting to have this case as soon as I finished an assignment on “A Letter from Prison,” which pertained to illegal methods of recognizing revenues. It is evident from this case that it can be very difficult to determine how much revenue is earned, especially for a company like Apple that sells intangible products. Managers must follow the steps in ASC 606 and other codifications in order to estimate revenues most accurately in good faith.
a. Revenues are value earned by a business fulfilling an obligation related to the main functions of the business. Simply put, this would be payment for a product from a merchandise company and payment for a service from a service company. These differ from gains because gains are not related to the central business functions of a company. These are typically irregular and occur at random.

b. ASC 606 describes the steps in recognizing revenue to be as follows:

1. Identify the contract- This creates an agreement between parties and establishes obligations that must be fulfilled to recognize revenue. These do not have to be in writing

2. Identify performance obligations- identify distinct obligations that parties must fulfill. This would often include a customer paying a business and a business providing a service or product. If a service and product are involved, they are considered separate if “the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer and the entity’s promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.”

3. Determine the transaction price- this is the value of total consideration included in the contract
4. Allocate the transaction price to the performance obligations- individual independent values are used to allocate a percentage of the transaction to each obligation.

5. Recognize revenue when the entity satisfies the performance obligations-
When the seller completes the obligation, they should recognize revenue, for example, when a physical product is transferred to the customer or a service has been completed. This is probably where problems occur most frequently as often businesses have to estimate when revenue is earned over a period of time. For long term services like construction projects, the entity most often recognizes a portion of the revenue as the building progresses rather than all at once when it is finished

Many accounts and statements are affected by when revenues are recognized. Income on the income statement will obviously be higher when revenues are recognized and balance sheet accounts such as unearned revenue are affected by how much revenue is recognized and when. If a company accrues revenue, receivables on the balance sheet will increase as well. Overall, recognizing revenue is the company claiming that that portion of the total sales value has been fulfilled.
c. In its most recent 10k, Apple states it recognizes revenues when “persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed, and collection is probable. There is also a note describing how the company will adopt the new revenue recognition standard in 2019 and that and differences will be presented retrospectively. It seems that the methods Apple is using now covers most of the steps in ASC 606 but not all. In 2019, however, Apple will be fully aligned with these criteria.

d. As briefly described in part c, some contracts contain multiple performance obligations. In these multiple-element contracts, the company must allocate the transaction price to each obligation. This can be difficult because it is sometimes hard to determine the stand alone price of certain elements, and it may take longer to recognize revenue on one element than another. For Apple, many of these contracts include software and physical hardware that runs the software. Since the software is intangible, it is difficult to determine a standalone price.

e. There are many reasons managers would use “self-serving” revenue recognition. These include compensation for higher sales, pressure from executives and the Board of Directors to reach target revenues, and pressure from the outside investment community to reach estimates. In an article I read recently, “A Letter from Prison,” Stephen Richards wrote about this dilemma, referencing his tenure at Computer Associates International. Richards and several other managers in his
company were found guilty of recognizing revenues too early or too late in order to make the revenues fall into a certain quarter. He explains that the pressure to meet target numbers is probably the main incentive to use these types of self-serving techniques.

f.

i. Because Apple does not own the rights to the songs, the company recognizes only commission from the sales when they take place.

ii. If sold in the Apple store, revenues are recognized as soon as the goods are transferred to the customer. For online sales, the company must wait until the customer receives the package because their performance obligation would not be satisfied if it were recognized at the time of sale.

iii. Revenue should be recognized as soon as ownership is transferred to the reseller. It is no longer Apple’s obligation to sell the iPods once they are purchased by the reseller.

iv. When a gift card is purchased, Apple should record the transaction as unearned revenue because they still have the obligation to fulfill transactions for the amount purchased. Once the gift card is used and the customer buys something, Apple can record the revenue as earned.
On my honor, I pledge that I have neither giver, received, nor witnessed any unauthorized help on this thesis.