A BASIC UNDERSTANDING OF ACCOUNTING PRINICIPLES: A CASE-BY-CASE STUDY

by
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Approved by

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ABSTRACT

A Learning of Financial Statements

To complete my thesis, the Patterson School of Accountancy and the Sally McDonnell Barksdale Honors college created a special class just for accounting majors to complete their theses on time. This thesis is a collection of case studies illustrating many topics in the study of accounting. Each case study covers a different topic including the revenue cycle, leases, fraud, inventory classification, and much more. Data is presented in financial statements, tables, and in reports. Instead of covering one topic, the topics examined are all topics/issues an accountant could face throughout their career. An accountant has many different faces: financial advisor, tax consultant, fraud investigator, financial statement preparer. Each case encompasses one of these different faces and illustrates the many different jobs an accountant completes in their career.

Every week, we were given a new case to complete. Some of the cases involved solving a problem for a company, researching the fraud effects of a company, or simply prepare a set of financial statements for a company. Most of the cases were completed with groups assigned to our class each week. We were given a week to complete the case, and then our professor and thesis advisor, Dr. Dickinson, would review our cases and provide valuable feedback. Even though many of the cases were completed in groups, each student's thesis is an individual piece with different insights into the cases based on each student's personal findings. Some cases required the use of outside research and others did not. This thesis is a comprehensive study of many topics in accounting.

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Case 1: Home Heaters

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Executive Summary

Two companies at the beginning of 20X1 began selling home heating units, Glenwood Heating, Inc., located in Glenwood Springs, Colorado, and Eads Heaters, Inc., located in Eads, Colorado. Both companies perform under similar economic conditions and have matching operations throughout the year. The two companies also had identical transactions during the first year of business, 20X1. Despite these similarities, each company makes different accounting decisions and estimates after applying generally accepted accounting principles (GAAP) when preparing financial statements for the company.

To prepare the financial statements, I first needed to create journal entries of all the different transactions that had occurred over the past year for both companies. Next, I made any adjusting entries that needed to be made in both companies. Since Glenwood Heating, Inc. and Eads Heaters, Inc. make different accounting choices, I had to approach each company separately and make the correct entry for each individual company. After the adjusting entries were made, I created a trial balance. A trial balance is a list of all open accounts in the general ledger with all the balances after all adjustments have been posted. From the trial balance, I was able to create the rest of the financial statements, a multistep income statement, a statement of changes in stockholder's equity, a classified balance sheet, and a statement of cash flows. From the financial statements, I was able to compare the two different companies and develop an analysis of each company. The succeeding report presents an examination of each company's operations and an analysis of the different accounting decisions and estimates the two companies made during the year 20X1.

Financial Evaluation: Glenwood Heating, Inc.

Glenwood Heating, Inc. has had a very successful first year of operations. The company managed to keep their expenses lower than their amount of revenues, and they generated a high net income of $92,742 for the year as seen by Glenwood Heating's, Inc. income statement for 20X1. Glenwood Heating, Inc. was also able to distribute dividends to their many investors, leaving them with $69,452 of retained earnings, shown in the statement of changes in stockholders' equity. Throughout 20X1, Glenwood Heating, Inc. has created a home heating unit business that will continue to do well in the home heating market. The financial statements for Glenwood Heating, Inc. are in the appendix at the end of the report.

Financial Evaluation: Eads Heaters, Inc.

Eads Heaters, Inc. also had a very successful first year of operations in 20X1. The company generated a sensible net income of $70,515 illustrated in the company's income statement. Distributing the same number of dividends to investors as Glenwood Heating, Inc., Eads Heaters, Inc. ended the year with $47,315 of retained earnings shown in the statement of changes in stockholders' equity below. The company experienced higher expenses resulting in a lower operating income of $129,030. The financial statements for Eads Heaters, Inc. are in the appendix at the end of the report.

Analysis

After comparing and reviewing the financials for Glenwood Heating, Inc. and Eads Heaters Inc., I have decided to urge stakeholders to invest in Glenwood Heating, Inc. These businesses are both very new, and they both have done a remarkable job this year, however Glenwood's financials show the company has been superior in the market. When looking through Glenwood's financials, one can see that they have a higher net income of over $20,000 than Eads. Glenwood Heating Inc. has done an excellent job of keeping expenses low resulting in a high operating income.

When comparing the statement of changes in stockholders' equity for each company, one can see why Glenwood is the better company. According to the statement, Glenwood Heating, Inc. has maintained $69,542 of retained earnings, whereas Eads Heaters, Inc. has only maintained a value of retained earnings at $47,315. This is in part because Glenwood has a much higher net income than Eads. By keeping their operating expenses low, Glenwood was able to develop $30,000 more of operating income than Eads. Even though Glenwood Heating Inc. spends more money on rent than Eads, their lower depreciation expense and bad debt expense helps them sustain lower expenses. Glenwood Heating Inc. has a lower dollar amount for cost of goods sold, which are the direct costs traced to the production of heating units sold. Cost of goods sold includes the materials used to produce the units and the direct labor costs used to create the good. Glenwood could have been able to produce the goods with less employees or used cheaper materials in producing the home heating units.

Next, I compared the statement of cash flows for each company. The statement of cash flows reports the amount of cash generated and used throughout the year. This statement informs investors and stakeholders how the company is using their cash during the year. Upon looking at the statements, one sees that both companies report a deficit after operating and investing activities. Continuing down the statement, Eads reported a higher cash balance by around $7,000. This is not detrimental to investing in Glenwood Heating, Inc. because the company is just in its first year of business, and still has room and time to grow. Glenwood has done so well in other aspects investors should not be alarmed by the low cash amount reported in the company's statement of cash flows.

After thoroughly reviewing each financial statement, I calculated some ratios to more adequately compare the two companies. The ratios helped me better understand each company and give me a clearer picture of each businesses' success during each's first year of operations. I calculated each company's inventory turnover to find how often the two companies were turning over their home heating units. Glenwood Heating, Inc. had a turnover ratio of 6.34 days, while Eads Heaters, Inc. had a ratio of 7.14 days. Even though these ratios are very close, that little bit of time can help a company provide more heating units. The next ratio I computed was the times interest earned ratio, to determine each company's ability to honor its debt payments. I calculated it by dividing the income before interest and taxes by the interest expense. Investors want to invest in a company that is trustworthy and stable. Glenwood had a ratio of 5.47 times, while Eads's ratio was 3.69 times. Both companies have excellent ratios with Glenwood's being higher, encouraging investors to invest in the less risky company. Both companies performed well in their first year of business, but Glenwood Heating Inc. managed to perform slightly better than Eads Heaters, Inc. I believe investors should invest their money into Glenwood Heating, Inc. based on my research and evaluation from each company's financials.

Case 1: Appendix

Glenwood Heating, Inc. Financials

Glenwood Heating, Inc.

Chart of Accounts

As of December 31, 20X1

	Assets						Liabilities			Equity	
Part A	Cash	Accounts Receivable	Inventory	Land	Building	Equipment	Accounts Payable	Notes Payable	Interest Payable	Common Stock	Retained Earnings
No.1	$160,000.00									$160,000.00	
No.2	$400,000.00							$400,000.00			
No.3	-$420,000.00			$70,000.00	$350,000.00						
No.4	-$80,000.00					$80,000.00					
No.5			$239,800.00				$239,800.00				
No.6		$398,500.00									$398,500.00
No.7	$299,100.00	-$299,100.00									
No.8	-$213,360.00						-$213,360.00				
No.9	-$41,000.00							-$20,000.00			-$21,000.00
No.10	-$34,200.00										-$34,200.00
No.11	-$23,200.00										-$23,200.00
No.12											-$6,650.00
Balances	$47,340.00	$99,400.00	$239,800.00	$70,000.00	$350,000.00	$80,000.00	$26,440.00	$380,000.00	-$6,650.00	$160,000.00	$313,450.00

Part B	Assets							
	Cash	Accounts Receivable	Allowance for Bad Debts	Inventory	Land	Building	Equipment	Accumulated Depreciation
Part A Balances	$47,340.00	$99,400.00	$0.00	$239,800.00	$70,000.00	$350,000.00	$80,000.00	$0.00
Bad Debt			$994.00					
Cost of Goods Sold				-$177,000.00				
Depreciation								
Building								$10,000.00
Equipment								$9,000.00
Equipment								
Rental Payme	-$16,000.00							
Income Tax	-$30,914.00							
Balances	$426.00	$99,400.00	$994.00	$62,800.00	$70,000.00	$350,000.00	$80,000.00	$19,000.00

	Liabilities				Equity	
	A/P	N/P	I/P		C/S	R/E
Part A Balances	$26,440.00	$380,000.00	-$6,650.00		$160,000.00	$313,450.00
Bad Debt						-$994.00
Cost of Goods Sold						-$177,000.00
Depreciation						
Building						-$10,000.00
Equipment						-$9,000.00
Equipment						
Rental Payme						-$16,000.00
Income Tax						-$30,914.00
Balances	$26,400.00	$380,000.00	-$6,650.00		$160,000.00	$69,542.00

General Journal			
Date	Account Name	Debit	Credit
2-Jan	Cash	160,000.00	
	Common Stock		160,000.00
	to record the issuance of stock		
2-Jan	Cash	400,000.00	
	Notes Payable		400,000.00
	to record the borrowing of cash		
3-Jan	Land	70,000.00	
	Building	350,000.00	
	Cash		420,000.00
	to record purchase of land and building		
5-Jan	Equipment	80,000.00	
	Cash		80,000.00
	to record purchase of equipment		
5-Jan	Inventory	239,800.00	
	Accounts Payable		239,800.00
	to record purchase of inventory		
5-Jan	Accounts Receivable	398,500.00	
	Sales		398,500.00
	to record sales of units		
5-Jan	Cash	299,100.00	
	Accounts Receivable		299,100.00
	to record payment of units		
5-Jan	Accounts Payable	213,360.00	
	Cash		21,360.00
	to record payment to supplier		
30-Sep	Notes Payable	20,000.00	
	Interest Expense	21,000.00	
	Cash		41,000.00
	to record payment and interest on note		
30-Sep	Other Operating Expenses	34,200.00	
	Cash		34,200.00
	to record a variety of expenses		
30-Sep	Dividends	23,200.00	
	Cash		23,200.00
	to record dividends paid to stockholders		
30-Sep	Interest Expense	6,650.00	
	Interest Payable		6,650.00
	to record interest on note		
Sep-31	Bad Debt Expense	994.00	
	Allowance for Doubtful Accounts		994.00
	to record bad debt expense		
Sep-31	Cost of Goods Sold	177,000.00	
	Inventory		177,000.00
	to record cost of goods sold		
Sep-31	Depreciation Expense	10,000.00	
	Accumulated Depreciation, Building		10,000.00
	Depreciation Expense	9,000.00	
	Accumulated Depreciation, Equipment		9,000.00
	to record depreciation		
Sep-31	Rent Expense	16,000.00	
	Cash		16,000.00
	to record rent of equipment		
Sep-31	Provisions from Income Tax	30,914.00	
	Cash		30,914.00
	to record income tax		

Glenwood Heating, Inc.		
Trial Balance		
	$	$
Asset Accounts		
Cash	426.00	
Accounts Receivable	99,400.00	
Allowance for Bad Debts		994.00
Inventory	62,800.00	
Land	70,000.00	
Building	350,000.00	
Accumulated Depreciation, Building		10,000.00
Equipment	80,000.00	
Accumulated Depreciation, Equipment		9,000.00
Leased Equipment		
Accumulated Depreciation, Leased Equipment		
Liability Accounts		
Accounts Payable		26,440.00
Interest Payable		6,650.00
Notes Payable		
Lease Payable		380,000.00
Equity Accounts		
Common Stock		160,000.00
Retained Earnings		
Dividends	23,200.00	
Sales		398,500.00
Cost of Goods Sold	177,000.00	
Bad Debt Expense	994.00	
Depreciation Expense	19,000.00	
Interest Expense	27,650.00	
Other Operating Expenses	34,200.00	
Rent Expense	16,000.00	
Provision for Income Taxes	30,914.00	
TOTALS:	991,584.00	991,584.00

Glenwood Heating, Inc.		
Income Statement		
For Year Ended December 31, 20X1		
	$	$
Sales		398,500.00
Cost of Goods Sold		(177,000.00)
Gross Profit		221,500.00
Operating Expenses		
Rent Expense	16,000.00	
Depreciation Expense	19,000.00	
Bad Debt Expense	994.00	
Other Operating Expenses	34,200.00	
Total Operating Expenses		(70,194.00)
Operating Income		151,306.00
Non-Operating or Other		
Interest Expense	27,650.00	
Provision for Income Taxes	30,914.00	
Total Non-Operating		(58,564.00)
Net Income		92,742.00
		`

Glenwood Heating, Inc.				
Statement of Changes in Stockholders' Equity				
For Year Ended December 31, 20X1				
		Common Stock	Retained Earnings	Total Stockholder's Equity
Balances 1/1/20X1		-	-	-
Issued Shares		160,000.00		160,000.00
Net Income			92,742.00	92,742.00
Dividends			(23,200.00)	(23,200.00)
Balances 12/31/20X1		160,000.00	69,542.00	229,542.00

Glenwood Heating, Inc.				
Balance Sheet				
As of December 31, 20X1				
Assets	$		**Liabilities**	$
Current Assets			Current Liabilities	
Cash	426.00		Accounts Payable	26,440.00
Net Accounts Recievable	98,406.00		Interest Payable	6,650.00
Inventory	62,800.00		Notes Payable	380,000.00
Property, Plant, & Equipment			Total Liabilities	413,090.00
Land	70,000.00			
Building	350,000.00		**Equity**	
Equipment	80,000.00		Common stock	160,000.00
Less Accumulated Depcreciation	(19,000.00)		Retained Earnings	69,542.00
			Total Equity	229,542.00
Total Assets	642,632.00		**Total Liabilities and Equity**	642,632.00

Glenwood Heating, Inc.		
Statement of Cash Flows		
For Year Ended December 31, 20X1		
Cash Flows from Operating Activities	$	$
Net Income		92,742.00
Adjustments to Reconcile Net Income		
Depreciation Expense	19,000.00	
Accounts Receivable	99,400.00	
Allowance for Bad Debts	994.00	
Inventory	62,800.00	
Accounts Payable	26,440.00	
Interest Payable	6,650.00	
Cash Flow from Operating Activities		(16,374.00)
Cash Flow from Investing Activities		
Purchase of Land	(350,000.00)	
Purchase of Building	(70,000.00)	
Purchase of Equipment	(80,000.00)	
Cash Flow from Investing Activities		(500,000.00)
Cash Flow from Financing Activities		
Line of Credit	380,000.00	
Common Stock	160,000.00	
Dividends	(23,200.00)	
Cash Flow from Financing Activities		516,800.00
Beginning Cash Balance		-
Net Cash Flows		426.00
Ending Cash Balance		426.00

Glenwood Heating Inc. Calculations

Schedule of Purchases-JE5			
Month	Units	Cost per Unit	Total Cost
Jan	40	1,000.00	40,000.00
Mar	60	1,100.00	66,000.00
Jun	20	1,150.00	23,000.00
Sept	62	1,200.00	74,400.00
Oct	28	1,300.00	36,400.00
			239,800.00

Schedule of COGS-AJE2		
Units	Cost/Unit	Total
40	1000	40,000.00
60	1100	66,000.00
20	1150	23,000.00
40	1200	48,000.00
	4450	177,000.00

Schedule of Depreciation-AJE3	
Building	$ 10,000.00
Equipment	$ 9,000.00
Total	$ 19,000.00

Eads Heaters, Inc. Financials

Eads Heaters, Inc.
Chart of Accounts
As of December 31, 20X1

	Assets						Liabilities			Equity	
Part A	Cash	Accounts Receivable	Inventory	Land	Building	Equipment	Accounts Payable	Notes Payable	Interest Payable	Common Stock	Retained Earnings
No.1	$160,000.00									$160,000.00	
No.2	$400,000.00							$400,000.00			
No.3	-$420,000.00			$70,000.00	$350,000.00						
No.4	-$80,000.00					$80,000.00					
No.5			$239,800.00				$239,800.00				
No.6		$398,500.00									$398,500.00
No.7	$299,100.00	-$299,100.00									
No.8	-$213,360.00						-$213,360.00				
No.9	-$41,000.00							-$20,000.00			-$21,000.00
No.10	-$34,200.00										-$34,200.00
No.11	-$23,200.00										-$23,200.00
No.12											-$6,650.00
Balances	$47,340.00	$99,400.00	$239,800.00	$70,000.00	$350,000.00	$80,000.00	$26,440.00	$380,000.00	-$6,650.00	$160,000.00	$313,450.00

Part B	Assets							
	Cash	Accounts Receivable	Allowance for Bad Debts	Inventory	Land	Building	Equipment	Accumulation Depreciation
Part A Balances	$47,340.00	$99,400.00	$0.00	$239,800.00	$70,000.00	$350,000.00	$80,000.00	$0.00
(1) Bad Debt			$4,970.00					
(2) Cost of Goods Sold				$188,800.00				
(3) Depreciation								
Building								$10,000.00
Equipment								$20,000.00
(4)Equipment								
Lease								
Lease Payment	-$16,000.00							
Depreciation								$11,500.00
Income Tax	-$23,505.00							
Balances	$7,835.00	$99,400.00	$4,970.00	$51,000.00	$70,000.00	$350,000.00	$80,000.00	$41,500.00

[redacted]

	Liabilities				Equity	
	Accounts Payable	Notes Payable	Interest Payable		Common Stock	Retained Earnings
Part A Balances	$26,440.00	$380,000.00	-$6,650.00		$160,000.00	$313,450.00
(1) Bad Debt						-$4,970.00
(2) Cost of Goods Sold						-$188,800.00
(3) Depreciation						
Building						-$10,000.00
Equipment						-$20,000.00
(4) Equipment						
Lease						
Lease Payment						-$7,360.00
Depreciation						-$11,500.00
(5) Income Tax						-$23,505.00
Balances	$26,440.00	$380,000.00	-$6,650.00			$47,315.00

General Journal			
Date	Account Name	Debit	Credit
2-Jan	Cash	160,000.00	
	Common Stock		160,000.00
	to record the issuance of stock		
2-Jan	Cash	400,000.00	
	Notes Payable		400,000.00
	to record the borrowing of cash		
3-Jan	Land	70,000.00	
	Building	350,000.00	
	Cash		420,000.00
	to record purchase of land and building		
5-Jan	Equipment	80,000.00	
	Cash		80,000.00
	to record purchase of equipment		
5-Jan	Inventory	239,800.00	
	Accounts Payable		239,800.00
	to record purchase of inventory		
5-Jan	Accounts Receivable	398,500.00	
	Sales		398,500.00
	to record sales of units		
5-Jan	Cash	299,100.00	
	Accounts Receivable		299,100.00
	to record payment of units		
5-Jan	Accounts Payable	213,360.00	
	Cash		21,360.00
	to record payment to supplier		
30-Sep	Notes Payable	20,000.00	
	Interest Expense	21,000.00	
	Cash		41,000.00
	to record payment and interest on note		
30-Sep	Other Operating Expenses	34,200.00	
	Cash		34,200.00
	to record a variety of expenses		
30-Sep	Dividends	23,200.00	
	Cash		23,200.00
	to record dividends paid to stockholders		
30-Sep	Interest Expense	6,650.00	
	Interest Payable		6,650.00
	to record interest on note		
Sep-31	Bad Debt Expense	4,970.00	
	Allowance for Doubtful Accounts		4,970.00
	to record bad debt expense		
Sep-31	Cost of Goods Sold	188,800.00	
	Inventory		188,800.00
	to record cost of goods sold		
Sep-31	Depreciation Expense	10,000.00	
	Accumulated Depreciation, Building		10,000.00
	Depreciation Expense	20,000.00	
	Accumulated Depreciation, Equipment		20,000.00
	to record depreciation		
Sep-31	Lease Equipment	92,000.00	
	Lease Payable		92,000.00
	Interest Expense	7,360.00	
	Lease Payable	8,640.00	
	Cash		16,000.00
	Depreciation Expense	11,500.00	
	Accumulated Depreciation, Leased Equipment		11,500.00
	to record lease of equipment and interest		
Sep-31	Provisions for Income Tax	23,505.00	
	Cash		23,505.00
	to record income tax		

Eads Heaters, Inc.		
Trial Balance		
	$	$
Asset Accounts		
Cash	7,835.00	
Accounts Receivable	99,400.00	
Allowance for Bad Debts		4,970.00
Inventory	51,000.00	
Land	70,000.00	
Building	350,000.00	
Accumulated Depreciation, Building		10,000.00
Equipment	80,000.00	
Accumulated Depreciation, Equipment		20,000.00
Leased Equipment	92,000.00	
Accumulated Depreciation, Leased Equipment		11,500.00
Liability Accounts		
Accounts Payable		26,440.00
Interest Payable		6,650.00
Notes Payable		380,000.00
Lease Payable		83,360.00
Equity Accounts		
Common Stock		160,000.00
Retained Earnings		
Dividends	23,200.00	
Sales		398,500.00
Cost of Goods Sold	188,800.00	
Bad Debt Expense	4,970.00	
Depreciation Expense	41,500.00	
Interest Expense	35,010.00	
Other Operating Expenses	34,200.00	
Rent Expense		
Provision for Income Taxes	23,505.00	
TOTALS:	1,101,420.00	1,101,420.00

Eads Heaters, Inc.		
Income Statement		
For Year Ended December 31, 20X1		
	$	$
Sales		398,500.00
Cost of Goods Sold		(188,800.00)
Gross Profit		209,700.00
Operating Expenses		
Rent Expense		
Depreciation Expense	41,500.00	
Bad Debt Expense	4,970.00	
Other Operating Expenses	34,200.00	
Total Operating Expenses		(80,670.00)
Operating Income		129,030.00
Non-Operating or Other		
Intereset Expense	35,010.00	
Provision for Income Taxes	23,505.00	
Total Non-Operating		(58,515.00)
Net Income		70,515.00

Eads Heaters, Inc.			
Balance Sheet			
As of December 31, 20X1			
Assets	$	**Liabilities**	$
Current Assets		Current Liabilities	
Cash	7,835.00	Accounts Payable	26,440.00
Net Accounts Receivable	94,430.00	Interest Payable	6,650.00
Inventory	51,000.00	Longterm Liabilities	
Property, Plant, & Equipment		Notes Payable	380,000.00
Land	70,000.00	Lease Payable	83,360.00
Building	350,000.00	Total Liabilities	496,450.00
Equipment	80,000.00		
Leased Equipment	92,000.00	**Equity**	
Less Accumulated Depreciation	(41,500.00)	Common Stock	160,000.00
		Retained Earnings	47,315.00
		Total Equity	207,315.00
Total Assets	703,765.00	**Total Liabillities and Equity**	703,765.00

Eads Heaters, Inc.			
Statement of Changes in Stockholders' Equity			
For Year Ended December 31, 20X1			
	Common Stock	Retained Earnings	Total Stockholders' Equity
Balances 1/1/20X1	-	-	-
Issued Shares	160,000.00		160,000.00
Net Income		70,515.00	70,515.00
Dividends		(23,200.00)	(23,200.00)
Balances 12/31/20X1	160,000.00	47,315.00	207,315.00

Eads Heaters, Inc.		
Statement of Cash Flows		
For Year Ended December 31, 20X1		
Cash Flows from Operating Activities	$	$
Net Income		70,515.00
Adjustments to Reconcile Net Income		
Depreciation Expense	41,500.00	
Accounts Receivable	(99,400.00)	
Allowance for Bad Debts	4,970.00	
Inventory	(51,000.00)	
Accounts Payable	26,440.00	
Interest Payable	6,650.00	
Cash Flow from Operating Activities		(325.00)
Cash Flow from Investing Activities		
Purchase of Land	(350,000.00)	
Purchase of Building	(70,000.00)	
Purchase of Equipment	(80,000.00)	
Capital Lease Payment	(8,640.00)	
Cash Flow from Investing Activities		(508,640.00)
Cash Flow from Financing Activities		
Line of Credit	380,000.00	
Common Stock	160,000.00	
Dividends	(23,200.00)	
Cash Flow from Financing Activities		516,800.00
Beginning Cash Balance		-
Net Cash Flows		7,835.00
Ending Cash Balance		7,835.00

Eads Heaters Inc. Calculations

Schedule of Purchases-JE5			
Month	Units	Cost per Unit	Total Cost
Jan	40	1,000.00	40,000.00
Mar	60	1,100.00	66,000.00
Jun	20	1,150.00	23,000.00
Sept	62	1,200.00	74,400.00
Oct	28	1,300.00	36,400.00
			239,800.00

Schedule of COGS-AJE2		
Units	Cost/Unit	Total
28	1300	36,400.00
62	1200	74,400.00
20	1150	23,000.00
50	1100	55,000.00
	4850	188,800.00

Schedule of Depreciation-AJE3		
Building	$	10,000.00
Equipment	$	20,000.00
Leased Equipment	$	11,500.00
Total	$	41,500.00

Case 2: Totz and Doodlez

Table of Contents:

Executive Summary

Totz, a clothing retail store, sells high quality and chic fashion for children. The stores have made a trademark by attracting kids and their parents with loud, colorful stores. Totz, an SEC registrant, had its year end on the Saturday closest to January 31st. Totz decided to open an in-store art studio called Doodlez. Doodlez was introduced in the third quarter of the fiscal year 2015, which ended on January 31, 2015. The art studio offers all sorts of activities for children and adults such as pottery, painting, and drawing classes. Totz has asked me to analyze some financials to determine the appropriate income statement presentation for certain issues. I delved through the Financial Accounting Standards Board (FASB) Codification to determine solutions for these four problems arising within Totz financials. I examined how to present net sales with the addition of Doodlez, gross profit with the addition of Doodlez, a gain on a sale of corporate headquarters, and a class action settlement won by Totz. I found statements in the FASB Codification that lay out the correct and appropriate presentation of the four issues outlined by Totz.

Analysis

Net Sales

In the fiscal year of 2015, Totz had net sales of $74.5 million and in fiscal year 2016, had net sales of $86.5 million. Totz net sales increased by $12 million, or 16.1%. The dramatic increase in net sales was due, in part, by a large increase in revenue from services provided by Doodlez. Doodlez net sales increased from $3.9 million in 2015 to $11.2 million in 2016. Overall Doodlez increased Totz's net sales by $7.3 million. The remaining increase in net sales comes from an increase in the average transaction value, motivated by higher average retail sales on a per unit basis due to the satisfactory customer response because of the use of more natural fibers in its clothes. Totz asked how to portray this increase of net sales with the help of Doodlez in its income statement.

After reviewing the information about net sales provided by Totz, I examined the FASB Codification and believe that 225-10-S99-2 is the answer to Totz formatting dilemma. 225-10-S99-2 states:

> "(b) If income is derived from more than one of the sub captions described under § 210.5–03.1, each class which is not more than 10 percent of the sum of the items may be combined with another class. If these items are combined, related costs and expenses as described under § 210.5–03.2 shall be combined in the same manner."

When looking through Doodlez contributions to total net sales, one can see that in 2016 Doodlez sales account for 14.87% ($74.3 million/$11.2 million) of the net sales for Doodlez. This means that since Doodlez has more than 10% of the sum of the items it cannot be combined with another class, and therefore must be presented separately from Totz in the income statement. 225-10-S99-2 continues to say:

> "Net sales and gross revenues. State separately:
>
> (a) Net sales of tangible products (gross sales less discounts, returns and allowances), (b) operating revenues of public utilities or others; (c) income from rentals; (d) revenues from services; and (e) other revenues."

The sales attributed to Doodlez would classify as revenues from services because Doodlez offers services through its many different types of art classes. However, Totz does not sell services but sells a product of stylish clothing for children. This results in Totz needing to separate the service revenue gained from Doodlez in the presentation of their income statement.

Gross Profit

Totz saw an increase in gross profit (net sales less cost of goods sold or cost of sales) from $28 million in 2015 to $30.4 million in 2016. This is an increase of $2.4 million, or 8.6%. Cost of goods sold includes all expenses such as import costs, all product costs, and direct labor costs for the employees at Totz. Cost of goods sold does not include depreciation of any equipment, supplies, or any other plant assets. In 2016, cost of sales increased by $9.6 million, or 20.6%. This increase is due to the increase in the cost of services provided by Doodlez. Totz needs to know how to present the gross profit in their income statement.

The cost of sales incurred to acquire and produce inventory for sale should be placed under other operating expenses in the company's income statement. 225-10-S99-2 from the FASB Codification states:

> "Costs and expenses applicable to sales and revenues. State separately the amount of (a) cost of tangible goods sold, (b) operating expenses of public utilities or others, (c) expenses applicable to rental income, (d) cost of services, and (e) expenses applicable to other revenues. Merchandising organizations, both wholesale and retail, may include occupancy and buying costs under caption 2(a). Amounts of costs and expenses incurred from transactions with related parties shall be disclosed."

Stated by the rule above, each company's gross profit should be listed separately to disclose the correct operating amounts. Earlier we discussed the companies need to separate net sales and the same will need to be done for the gross profits of each.

Totz created Doodlez in the middle of fiscal year 2016, making it a new company. According to the FASB Codification 225-10-S99-3 states:

> "Therefore, in specific situations, the staff has required the subsidiary to revise its financial statements to include certain expenses incurred by the parent on its behalf. Examples of such

> expenses may include, but are not necessarily limited to, the following (income taxes and interest are discussed separately below): 1. Officer and employee salaries, 2. Rent or depreciation, 3. Advertising."

Totz incurred expenses prior to creating Doodlez in fiscal year 2016, including expenses with the formation of the new art-studio. Doodlez needs to account for those expenses even though they did not directly incur those costs. These costs could be advertising costs, employee salaries, etc. The information given does not explicitly list all the expenses, but we can infer such costs were incurred with the formation of a new business. Totz needs to be mindful not to overstate its' cost of sales. According to the FASB Codification 225-100-S99-8:

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

If Totz and Doodlez overstate their cost of sales, they could place undue emphasis on 'cash flow'. As the statement explains above, to avoid this error, Totz and Doodlez should not place depletion, depreciation, and amortization on the income statement in a way that results in portraying the figure for income before depreciation.

Gain on Sale of Corporate Headquarters

After lots of discussion and business evaluation, Totz decided to relocate its' headquarters to Mountain View, CA. Totz believed that by relocating they could expand their business and open the market for more customers. With the relocation, Totz sold an abandoned building and realized a gain of $1.7 million. This gain on the abandoned building is classified as a gain on discontinued operations, since the building was vacant at the time of the sale.

Upon analyzing the Codification, I discovered Statement 205-20-45-1 which states:

> "The results of operations of a component of an entity that either has been disposed of or is classified as held for sale under the requirements of paragraph 360-10-45-9, shall be reported in discontinued operations in accordance with paragraph 205-20-45-3 if both of the following conditions are met: (A.) The operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction. (B.) The entity will not have any significant continuing involvement in the operations of the component after the disposal transaction."

The above rule explains why the abandoned property should be classified as a discontinued operation if the property is not having any continuing involvement in the operations of the business and the cash flows from the property have been eradicated from operations. The Codification goes on to say in 205-20-45-3A:

> "The results of all discontinued operations, less applicable income taxes (benefit), shall be reported as a separate component of income. For example, the results of all discontinued operations may be reported in the statement where net income of a business entity is reported as follows."

Income from continuing operations before income taxes	$XXXX	
Income taxes	XXX	
Income from continuing operations		$XXXX
Discontinued operations (Note X)		
Loss from operations of discontinued Component X (including loss on disposal of $XXX)		XXXX
Income tax benefit		XXXX
Loss on discontinued operations		XXXX
Net income		$XXXX

The image above illustrates how to present the gain on sale of Totz's abandoned corporate headquarters on the income statement as a discontinued operation after taking out income taxes.

Class Action Settlement

During 2016, Totz discovered that the natural fiber materials provided by one of its fabric suppliers were not natural. The supplier had been lying to Totz to gain its business. Totz settled a class action lawsuit related to the legal case involving the misguidance of the supplier. Because of this lawsuit, Totz received $2.7 million from the distrustful supplier.

After reviewing the FASB Codification, I believe that the class action settlement should be disclosed in the notes of the income statement. 225-20-45-16 of the Codification states:

> "A material event or transaction that is unusual in nature or occurs infrequently but not both, and therefore does not meet both criteria for classification as an extraordinary item, shall be reported as a separate component of income from continuing operations. The nature and financial effects of each event or transaction shall be disclosed on the face of the income statement or, alternatively, in notes to financial statements. Gains or losses of a similar nature that are not individually material shall be aggregated. Such items shall not be reported on the face of the income statement net of income taxes or in any other manner that may imply that they are extraordinary items. Similarly, the EPS effects of those items shall not be presented on the face of the income statement."

This type of event is classified as "unusual in nature." The gain from the class action settlement should be disclosed in the notes section rather than directly on the income statement due to its unusual and infrequent nature.

Case 3: Rocky Mountain Chocolate Factory, Inc.

Table of Contents:

Rocky Mountain Chocolate Factory, Inc. **General Journal**		
Account Name	Debit	Credit
Inventories	7,500,000	
Accounts Payable		7,500,000
To record purchase of inventory on account		
Inventories	6,000,000	
Accrued Salaries and Wages		6,000,000
To record factory wages incurred		
Cash and Cash Equivalents	17,000,000	
Accounts Receivable	5,000,000	
Sales		22,000,000
To record sales for cash and on account		
Cost of Sales	14,000,000	
Inventories		14,000,000
To record cost of inventory sold		
Accounts Payable	8,200,000	
Cash and Cash Equivalents		8,200,000
To record payment of accounts payable to suppliers		
Cash and Cash Equivalents	4,100,000	
Accounts Receivable		4,100,000
To record collection of receivables		
Sales and Marketing Expenses	1,505,431	
General and Administrative Expenses	2,044,569	
Retail Operating Expenses	1,750,000	
Cash and Cash Equivalents		2,000,000
Other Accrued Expenses		3,300,000
To record payment and accrual of various expenses		
Accrued Salaries and Wages	6,423,789	
Cash and Cash Equivalents		6,423,789
To record payment of accrued wages		
Cash and Cash Equivalents	125,000	
Deferred Income		125,000
To record payment franchise fees received but not yet earned		
Property and Equipment	498,832	
Cash and Cash Equivalents		498,832
To record acquisition of property and equipment		

Retained Earnings	2,407,167	
Cash and Cash Equivalents		2,403,458
Dividend Payable		3,709
To record declaration and payment of dividends		
Cash and Cash Equivalents	790,224	
Notes Receivable, net	91,059	
Deferred Income, net	92,052	
Property and Equipment, net	132,859	
Notes Receivable, less current portion	139,198	
Other Accrued Expenses	2,885,413	
Dividend Payable	1	
Deferred Income	46,062	
Cost of Sales	693,786	
Franchise Contracts	1,499,477	
Income Tax Expense	2,090,468	
Accounts Receivable		702,207
Inventories		66,328
Other Current Assets		4,215
Intangible Assets, net		73,110
Other Long-term Assets		3,007
Accounts Payable		503,189
Deferred Income Taxes		66,729
Common Stock		1,112
Additional Pain in Capital		315,322
Sales		944,017
Franchise and Royalty Fees		5,492,531
General and Administrative Expenses		261,622
Interest Income		27,210
To record all other transactions		
Total:	$85,015,387.00	$85,015,387.00

Rocky Mountain Chocolate Factory, Inc

	Accounts	Beginning Balance	Purchase Inventory	Incur Factory Wages	Sell inventory for cash and on account	Pay for inventory	Collect receivables	Incur SG&A	Pay wages	Receive franchise fee	Purchase PPE	Dividends declared and paid	All other transactions	Unadjusted Trial Balance
	Cash and Cash Equivalents	1,253,947			17,000,000	(8,200,000)	4,100,000	(2,000,000)	(6,423,789)	125,000	(498,832)	(2,403,458)	790,224	3,743,092
	Accounts Receivable	4,229,733			5,000,000		(4,100,000)						(702,207)	4,427,526
	Notes Receivable, current												91,059	91,059
	Inventories	4,064,611	7,500,000	6,000,000	(14,000,000)								(66,328)	3,498,283
	Deferred Income Taxes	369,197											92,052	461,249
Dr	Other Current Assets	224,378											(4,215)	220,163
	Propert and Equipment, net	5,253,598									498,832		132,859	5,885,289
	Notes Receivable, less current	124,452											139,198	263,650
	Goodwill, net	1,046,944												1,046,944
	Intangible Assets,net	183,135											(73,110)	110,025
	Other Long-term Assets	91,057											(3,007)	88,050
	Accounts Payable	1,074,643	7,500,000			(8,200,000)							503,189	877,832
	Accrued Salaries and Wages	423,789		6,000,000					(6,423,789)					-
	Other Accrued Expenses	531,941						3,300,000					(2,885,413)	946,528
	Dividend Payable	598,986										3,709	(1)	602,694
	Deferred Income	142,000								125,000			(46,062)	220,938
Cr	Deferred Income Taxes	827,700											66,729	894,429
	Common Stock	179,696											1,112	180,808
	Additional Paid in Capital	7,311,280											315,322	7,626,602
	Retained Earnings	5,751,017										(2,407,167)		3,343,850
	Sales	-			22,000,000								944,017	22,944,017
	Franchise and Royalty Fees	-											5,492,531	5,492,531
	Cost of Sales	-			14,000,000								693,786	14,693,786
	Franchise Costs	-											1,499,477	1,499,477
	Sales and Marketing	-						1,505,431						1,505,431
Dr	General and Administrative	-						2,044,569					(261,622)	1,782,947
	Retail Operating	-						1,750,000						1,750,000
	Depreciation and Amoritization	-												-
	Interest Income	-											(27,210)	(27,210)
	Income Tax Expense	-	-	-	-	-	-	-	-	-	-	-	2,090,468	2,090,468

Rocky Mountain Chocolate Factory, Inc. Unadjusted Trial Balance		
Accounts	Debits	Credits
Cash and Cash Equivalents	3,743,092	
Accounts Receivable	4,427,526	
Notes Receivable, current	91,059	
Inventories	3,498,283	
Deferred Income Taxes	461,249	
Other Current Assets	220,163	
Property and Equipment, net	5,885,289	
Notes receivable, less current portion	263,650	
Goodwill, net	1,046,944	
Intangible Assets, net	110,025	
Other Long-term Assets	88,050	
Accounts Payable		877,832
Other Accrued Expenses		946,528
Dividend Payable		602,694
Deferred Income		220,938
Deferred Income Taxes		894,429
Common Stock		180,808
Additional Paid-in Capital		7,626,602
Retained Earnings		3,343,850
Sales		22,944,017
Franchise and Royalty Fees		5,492,531
Cost of Sales	14,693,786	
Franchise Costs	1,499,477	
Sales and Marketing	1,505,431	
General and Administrative	1,782,947	
Retail Operating	1,750,000	
Interest Income		27,210
Income Tax Expense	2,090,468	
Total:	$43,157,439	$43,157,439

Rocky Mountain Chocolate Factory, Inc. Adjusted Trial Balance		
Accounts	Debits	Credits
Cash and Cash Equivalents	3,743,092	
Accounts Receivable	4,427,526	
Notes Receivable, current	91,059	
Inventories	3,281,447	
Deferred Income Taxes	461,249	
Other Current Assets	220,163	
Property and Equipment, net	5,186,709	
Notes Receivable, less current portion	263,650	
Goodwill, net	1,046,944	
Intangible Assets, net	110,025	
Other Long-term Assets	88,050	
Accounts Payable		877,832
Other Accrued Expenses		946,528
Accrued Salaries and Wages		646,156
Dividend Payable		602,694
Deferred Income		220,938
Deferred Income Taxes		894,429
Common Stock		180,808
Additional Paid-in Capital		7,626,602
Retained Earnings		3,343,850
Sales		22,944,017
Franchise and Royalty Fees		5,492,531
Cost of Sales	14,910,622	
Franchise Costs	1,499,477	
Sales and Marketing	1,505,431	
General and Administrative	2,422,147	
Retail Operating	1,756,956	
Depreciation and Amortization	698,580	
Interest Income		27,210
Income Tax Expense	2,090,468	
Total:	$43,803,595	$43,803,595

	Accounts	Unadjusted Trial Balance	Adjust for Inventory Count	Record Depreciation	Wage Accrual	Consultant's Report	Pre-closing Trial Balance	Closing entry	Post-closing balance	Actual February 28th 2010 F/S figures
	Cash and Cash Equivalents	3,743,092					3,743,092		3,743,092	$3,743,092
	Accounts Receivable	4,427,526					4,427,526		4,427,526	4,427,526
	Notes Receivable, current	91,059					91,059		91,059	91,059
	Inventories	3,498,283	(216,836)				3,281,447		3,281,447	3,281,447
	Deferred Income Taxes	461,249					461,249		461,249	461,249
Dr	Other Current Assets	220,163					220,163		220,163	220,163
	Property and Equipment, net	5,885,289		(698,580)			5,186,709		5,186,709	5,186,709
	Notes Receivable, less current	263,650					263,650		263,650	263,650
	Goodwill, net	1,046,944					1,046,944		1,046,944	1,046,944
	Intangible Assets, net	110,025					110,025		110,025	110,025
	Other Long-term Assets	88,050					88,050		88,050	88,050
	Accounts Payable	877,832					877,832		877,832	877,832
	Accrued Salaries and Wages	-			646,156		646,156		646,156	646,156
	Other Accrued Expenses	946,528					946,528		946,528	946,528
	Dividend Payable	602,694					602,694		602,694	602,694
	Deferred Income	220,938					220,938		220,938	220,938
Cr	Deferred Income Taxes	894,429					894,429		894,429	894,429
	Common Stock	180,808					180,808		180,808	180,808
	Additional Paid-in Capital	7,626,602					7,626,602		7,626,602	7,626,602
	Retained Earnings	3,343,850					3,343,850	3,580,077	6,923,927	6,923,927
	Sales	22,944,017					22,944,017	(22,944,017)	-	22,944,017
	Franchise and Royalty Fees	5,492,531					5,492,531	(5,492,531)	-	5,492,531
	Cost of Sales	14,693,786	216,836				14,910,622	(14,910,622)	-	14,910,622
	Franchise Costs	1,499,477					1,499,477	(1,499,477)	-	1,499,477
	Sales and Marketing	1,505,431					1,505,431	(1,505,431)	-	1,505,431
Dr	General and Administrative	1,782,947			639,200		2,422,147	(2,422,147)	-	2,422,147
	Retail Operating	1,750,000			6,956		1,756,956	(1,756,956)	-	1,756,956
	Depreciation and Amortization	-		698,580			698,580	(698,580)	-	698,580
	Interest Income	(27,210)					(27,210)	27,210	-	(27,210)
	Income Tax Expense	2,090,468					2,090,468	(2,090,468)	-	2,090,468
	Total	-	-	-	-		-	-	-	$ (3,580,077)

f.	**Adjusting Entries**		
12	Cost of Sales	216,836	
	Inventories		216,836
	To adjust ending inventory to physical count		
13	Depreciation and amortization expense	698,580	
	Property and Equipment, net		698,580
	To record depreciation expense		
14	General and administrative expenses	639,200	
	Retail operating expense	6,956	
	Accrued salaries and wages		646,156
	To record wages payable		
15	No entry		

i.	**Closing Entries**		
	Sales	22,944,017	
	Franchise and Royalty Fees	5,492,531	
	Interest Income	27,210	
	Income Summary		28,463,758
	To close revenues to income summary		
	Income Summary	24,883,681	
	Cost of Sales		14,910,622
	Franchise Costs		1,499,477
	Sales and Marketing		1,505,431
	General and Administrative		2,422,147
	Retail Operating		1,756,956
	Depreciation and Amortization		698,580
	Income Tax Expense		2,090,468
	To close expenses to income summary		
	Retained Earnings	3,580,077	
	Income Summary		3,580,077
	To close retained earnings		

Rocky Mountain Chocolate Factory, Inc.
Balance Sheet
28-Feb-10

Assets	$	**Liabilities**	$
Cash and Cash Equivalents	$3,743,092	Accounts Payable	$877,832
Accounts Receivable	4,427,526	Accrued Salaries and Wages	646,156
Notes Receivable, current	91,059	Other Accrued expenses	946,528
Inventories	3,281,447	Dividend Payable	602,694
Deferred Income Taxes	461,249	Deferred Income	220,938
Other Current Assets	220,163	Total Current Liabilities	3,294,148
Total Current Assets	12,224,536		
		Long-Term Liabilities	
Property and Equipment, net	5,186,709	Deferred Income Taxes	894,429
Notes Receivable, less current	263,650		
Goodwill, net	1,046,944	**Stockholders' Equity**	
Intangible Assets, net	110,025	Common Stock	180,808
Other Long-term Assets	88,050	Additional Paid-in Capital	7,626,602
Total Assets	$18,919,914	Retained Earnings	6,923,927
		Total Stockholders' Equity	14,731,337
		Total Liabilities and Equity	$18,919,914

Rocky Mountain Chocolate Factory, Inc. Income Statement For Year Ended February 28, 2010	
Sales	$22,944,017
Franchise and Royalty Fees	5,492,531
Total Revenues	28,436,548
Cost of Sales	14,910,622
Franchise Costs	1,499,477
Sales and Marketing	1,505,431
General and Administrative	2,422,147
Retail Operating	1,756,956
Depreciation and Amortization	698,580
Operating Income	5,643,335
Interest Income	27,210
Income before tax	5,670,545
Income Tax Expense	2,090,468
Net Income	$3,580,077

-	Transaction	Cash Flow Classification
1	Purchase Inventory	Non-cash Operating
2	Incur Factory Wages	Non-cash Operating
3	Sell Inventory	Operating
4	Pay for Inventory	Non-cash Operating
5	Collect Receivables	Non-cash Operating
6	Incur SG&A	Operating
7	Pay Wages	Operating
8	Receive Franchise Fees	Operating
9	Purchase PPE	Investing
10	Dividends Declared/Paid	Financing
11	All Other Transactions	Operating, Financing, and Investing
12	Inventory Count Adjustment	Non-cash Operating
13	Record Depreciation	Non-cash Operating
14	Wage Accrual	Non-cash Operating
15	Consultant's Report	No Transaction

Case 4: Fraud Audit

List of Fraud Schemes	**Internal Control and Why?**
Lucy is the only store manager employed, which allows for an opportunity to falsify documents and transactions should rationalization and pressure coincide with the opportunity.	**Separation of Duties --** By adding an additional store manager, either a co-manager or assistant manager, responsibilities such as recording daily sales and preparing bank deposits would be separate. As a result, each manager's role will be coherent with the other and separate, allowing more room for transparency.
An employee could create fake advertising receipts and pay themselves.	**Approval Authority --** Kayla or another manager needs to approve certain transactions for the other employees.
An employee could return a product that should be unreturnable (i.e. a product that has already been opened, used, etc.), and they could use the product for themselves.	**Approval Authority --** Kayla or another manager needs to approve special types of transactions to better keep track of sales returns, etc.
If the single credit card machine is altered, it would be easy for an employee to cover up the transaction, especially since both cash registers link to the one credit card machine.	**Documentation --** Add a second credit card machine to better keep track of credit payments made on both registers.
The store's hard copy of the receipts could go missing or could be altered without Kayla's knowledge.	**Documentation --** The registers send an electronic copy to Kayla and the other managers in case something happens to the physical copies of receipts.

Since Lucy has access to the accounting system that allows her to record sales data and prepare bank deposits, she could easily misstate these documents. For example, she could understate the cash.	**Separation of Duties --** Give someone else access to the sales data and bank deposit information. By giving another person these duties, you are making it harder for Lucy to commit a crime without the other employees noticing.
Any of the employees could have the ability to take cash from the customers by skimming them of cash at the point of sales but not reporting the transaction.	**Documentation --** Using inventory receipts would allow Kayla to see what items were sold and what amounts of cash or credit sales should be recorded in the system.
Any of the employees could have the ability to take cash from the customers by skimming them of cash at the point of sales but not reporting the transaction.	**Physical Audits –** An audit of inventory allows there to be an account of all items sold; therefore, if there is missing inventory, there should be a sale to match it.
In any possible fraud scheme without a surveillance camera system, it could be impossible to prove fraudulent activity took place if there is no proof.	**Monitoring of Controls --** Kayla should set up surveillance cameras throughout the store, and she should be the only person that has access to the surveillance system and information.
Kayla's office was not locked and therefore, all the employees had access to her office and the records stored there.	**Access Controls --** Kayla needs to lock her office or have the locks changed if she locks them frequently to ensure other employees are unable to tamper with company financial records, information, etc.
Kayla does not have a system where employees feel they can tell her in confidence problems that arise in the company.	**Reporting System --** Set up a web-based reporting system so employees can confidentially report problems about the store management, sales transactions, inventory counts, other employee actions, etc., if necessary.
Charge the credit card higher and take the cash difference.	**Documentation –** Kayla should implement a system to where after the credit card is scanned an electronic receipt is sent to her computer, so she knows exactly how much is spent.

Employees could create fake receipts and pocket some of the store's money.	**Separation of Duties --** Kayla should have a third party pay the bills.

Case 5: Inventory Classification

1. I expect the raw materials inventory to have costs of all parts of the good that is in stock that have not been turned into finished goods. This includes direct materials and indirect materials. Raw materials inventory could also have costs relating to the shipping of the raw materials to the manufacturing plant. I expect the work-in-process inventory to have costs of goods that are currently in production and the costs of direct labor. Direct labor is related to the people that are directly associated with the production of the product. The costs allocated to finished goods inventory are the costs of the final product of the good. Finished goods could also include costs of storing the finished products. Work-in-process and finished goods inventories also can include some manufacturing overhead costs.
2. The three different inventories accounts are net of an estimated allowance for obsolete or unmarketable inventory. This account is based upon current inventory levels, sales trends, and historical experience. This could also be referred to as a contra-inventory/ asset account called Inventory Reserve. Inventory Reserve is a way for companies to anticipate any inventory losses before they happen. Management can also make estimates of market conditions and forecasts of future demand for the product. These are subject to change in time.

3. The inventory reserve or reserve for obsolete inventory account could appear on the balance sheet or in the notes section of the financial statements. This account is a contra assets account. The gross amount of inventory at the end of 2011 is $243,870 and the gross amount of inventory at the end of 2012 is $224,254. The reserve for obsolete inventory is attributable mostly to the finished goods inventory account because a company will account for if a product does not sell well you will attribute that loss to the finished goods account.
4. The entries to record the activity on the reserve for obsolete inventory accounting during the current year:

Cost of Goods Sold	13,348	
Obsolete Inventory		13,348
Obsolete Inventory	11,628	
Finished Goods Inventory		11,628

5. T-Accounts:

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

Cost of Goods Sold	
0	
572,549	
13,348	
585,897	

Raw Materials Inv.	
46,976	
438,561	
	442,068
43,469	

Work-in-Process Inv.	
1,286	
126,000	
442,068	
	568,735
619	

Finished Goods Inv.	
184,808	
	13,348
568,735	
	572,549
167,646	

6. Inventory turnover = $\frac{Cost\ of\ Sales}{Average\ Inventories,\ \ net}$

Prior Year (2011)→ $\frac{575,226}{\frac{233,070+268,591}{2}} = \frac{575,226}{250,831}$ = 2.29 times

Current Year (2012) → $\frac{585,897}{\frac{211,734+233,070}{2}} = \frac{585897}{222402}$ = 2.63 times

7. Inventory holding period = $\frac{365}{Inventory\ turnover\ ratio}$

Prior Year (2011) → $\frac{365}{2.29}$ = 159.39 or 160 days

Current Year (2012) → $\frac{365}{2.63}$ = 138.78 days or 139 days

Yes, the company is becoming more efficient. In 2012, it took the company less days to manufacture and sell its inventory in 2011.

8. 2012 → $\frac{Inventory\ reserve\ provision}{Finished\ goods\ inventory+provision} = \frac{13{,}348}{167{,}646+13{,}348} = 7.37$

As an investor or analyst, I would like the company to calculate debt to equity ratio, to measure a company's financial leverage. I would also like for the company to provide the return on assets, to determine how profitable a company is based on their total assets. This ratio would also show how efficient management is at using its assets to produce revenue. I would also like to know what causes the goods to become obsolete and how it affects the company's earnings.

Case 6: World Com and FASB

1.

i. The FASB Statement of Concepts No. 6 states that an asset is a future economic benefit gained or controlled by an entity as an outcome of a previous transaction. The FASB Statement of Concepts No.6 states that an expense is the using up of assets or liabilities from the production of goods or completion of services and other activities that institute a company's main business operations.

ii. Expenditures that simply maintain a given level of service should be expensed. Costs should be capitalized if all three of the below conditions are met:

a. the useful life of the asset must be increased,
b. the quantity of service produced from the asset must be increased, or
c. the quality of the units produced must be enhanced.

2. After initial capitalization, the cost of the expenditure is depreciated until it gets to salvage value. The assets on the balance sheet will decrease and net income on the income statement will also decrease because your depreciation expense will increase throughout the quarters.

3. WorldCom's "Line costs" are most likely charges paid to local telephone networks. The income statement lists WorldCom's line cost as $14,739,000,000 at the end of 2001. Listed below is the journal entry reporting the line costs:

Line Costs Expense	14,739,000,000	
Cash or Accounts Payable		14,739,000,000

4. WorldCom improperly capitalized charges paid to local telephone networks to complete calls. The CFO, Scott Sullivan had been moving a large portion of these expenses into the capital expenditures section instead of correctly placing them with operating expenses. By moving these expenses, Sullivan turned a loss in 2001 into a profit in 2002. Mr. Sullivan spread these line costs to an upcoming time when the predicted revenue might arrive.

5. These costs appeared under the Property, Plant, and Equipment section of the balance sheet possibly as transmission equipment or communications equipment. On the Statement of Cash Flows, these costs would appear as capital expenditures. The journal entry to record the improperly capitalized line costs for 2001 is:

PPP (Asset)	3,055,000,000	
Line Costs Expense		3,055,000,000

6. $771 million/22 years * 4/4 quarters = 35,045,454.55

$610 million/22 years * 3/4 quarters = 20,795,454.55

$743 million/22 years * 2/4 quarters = 16,886,363.64

$931 million/ 22 years * 1/4 quarters = 10,579,545.45

$83,306,818.19

Depreciation Expense	83,306,818.19	
Accumulated Depreciation		83,306,818.19

7.

WorldCom, Inc.	
Corrected Income Statement	
For Year Ended 12/31/01	
Income before taxes	2,393,000,000.00
Depreciation expense	83,306,818.19
Line costs that were improperly capatilized	(3,055,000,000.00)
Loss before taxes	(578,693,181.81)
Income tax benefit	202,542,613.60
Minority interest/non-controlling interest	35,000,000.00
Net Loss	(341,150,568.21)

Case 7: Liabilities

1. Targa Company has decided to restructure its business line in the upcoming months. On December 27, 20X1, Targa Company sent out formal notices notifying its employees of the upcoming changes and informing all employees about its severance packages upon the closing of the facility. In total, the company plans to cut back ten percent of its workforce. The current facility is going to be updated to expand for another division within the company. The following FASB rule can be used to support Targa Company's one-time employee termination criteria 420-10-25-4:

    > An arrangement for one-time employee termination benefits exists at the date the plan of termination meets all of the following criteria and has been communicated to employees (referred to as the communication date):
    >
    > a. Management, having the authority to approve the action, commits to a plan of termination.
    >
    > b. The plan identifies the number of employees to be terminated, their job classifications or functions and their locations, and the expected completion date.
    >
    > c. The plan establishes the terms of the benefit arrangement, including the benefits that employees will receive upon termination

(including but not limited to cash payments), in sufficient detail to enable employees to determine the type and amount of benefits they will receive if they are involuntarily terminated.

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

When Targa Company promised its employees, these benefits, they created an obligation, or liability. FASB rule 420-10-25-5 can be used to support this:

An entity's communication of a promise to provide one-time employee termination benefits is a promise that creates an obligation at the communication date to provide the termination benefits if employees are terminated.

FASB rule 420-10-25-9 further explains this:

If employees are required to render service until they are terminated in order to receive the termination benefits and will be retained to render service beyond the minimum retention period, a liability for the termination benefits shall be measured initially at the communication date based on the fair value of the liability as of the termination date, and shall be recognized ratably over the future service period.

For employees to receive this benefit the employees must continue service through the date Targa ceases production and closes the facility. Upon the termination of its employees, Targa has agreed to pay $2.5 million in termination benefits, $500,000 of severance pay, and compensate the facility manager with a $50,000 lump sum when the facility closes. All the employee benefit expenses should be classified as liability and a loss per FASB rule, 712-10-25-1:

> Nonretirement postemployment benefits offered as special termination benefits to employees shall be recognized as a liability and a loss when the employees accept the offer and the amount can be reasonably estimated. An employer that offers, for a short period of time, special termination benefits to employees, shall not recognize a loss at the date the offer is made based on the estimated acceptance rate.

2. Targa Company will also incur relocation costs of $500,000 and training costs of $1.5 million. These expenses should be classified as reengineering costs as they are incurred according to 720-45-55-1:

	Third Party		Internal	
Steps	Expense	Capitalize	Expense	Capitalize
Business process reengineering and information technology transformation:				
Preparation of request for proposal	a		a	
Current state assessment	a		a	
Process reengineering	a		a	
Restructuring work force	a		a	
Preliminary software project stage activities:				
Conceptual formulation of alternatives	b		b	
Evaluation of alternatives	b		b	
Determination of existence of needed technology	b		b	
Final selection of alternatives	b		b	
Application development stage activities:				
Design of chosen path, including software configuration and software interface		c		c
Coding		c		c
Installation to hardware		c		c
Testing, including parallel processing phase		c		c
Data conversion costs:				
a. Costs to develop or obtain software that allows for access of old data by new system		c		c
b. All other data conversion processes	b		b	
Training	b		b	
Post-implementation/operation stage activities:				
Training	b		b	
Application maintenance	b		b	
Ongoing support	b		b	
Acquisition of fixed assets:				
Purchase of new computer equipment, office furniture, or work stations		d	N/A	N/A
Reconfiguration of work area—architect fees and hard construction costs		d		d

The FASB further clarifies the rule by stating in 720-45-25-2:

> The following third-party or internally generated costs typically associated with business process reengineering shall be expensed as incurred:
>
> a. Preparation of request for proposal—the process of preparing a proposal.
>
> b. Current state assessment—the process of documenting the entity's current business process, except as it relates to current software structure. This activity is sometimes called mapping, developing an as-is baseline, flow charting, and determining current business process structure.
>
> c. Process reengineering—the effort to reengineer the entity's business process to increase efficiency and effectiveness. This activity is sometimes called analysis, determining best-in-class, profit and performance improvement development, and developing should-be processes.
>
> d. Restructuring the work force—the effort to determine what employee makeup is necessary to operate the reengineered business processes.

Targa Company can expense both costs internally and for its third-party partners who they have entered binding contracts with for the next eighteen months. All costs can be expensed when they are incurred.

Case 8: Equity

1. Merck's common shares

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

    ii. Merck has issued 2,983,508,675 common shares at December 31, 2007.

    iii. When I reconcile the number of shares at December 31, 2007 to the dollar value of common stock on the balance sheet, Common stock will equal 2,983,508,675*.01=$29,835,086.75.

    iv. Merck has held 811,005,791 shares in treasury at December 31, 2007.

    v. Merck has 2,172,502,884 (2,983,508,675-811,005,791) shares outstanding at December 31, 2007.

    vi. Merck's market capitalization on December 31,2007 was $125,157,891,147. I found this by multiplying shares outstanding times price per share Merck closed (2,172,502,884*$57.61).

2. Companies pay dividends on their common or ordinary shares to keep investors content and give them a return on their investments. Paying dividends shows that a company is profitable or could also mean that the company is no longer growing. When a company pays its dividends the share price decreases possibly showing slowed growth in the future. The company might not have many opportunities for growth in the next coming years.

3. Companies repurchase their own shares because they feel their shares are undervalued in the market, to increase earnings per share, to privatize to thwart possible takeover attempts or to limit outside control, to provide stick for employee stock compensation plans, to make a market in the stock by creating an artificial type demand, or to provide a tax efficient distribution to shareholders.
4. Retained Earnings 3,310,700,000

Retained Earnings	3,310,700,000	
Dividends Payable		3,400,000
Cash		3,307,300,000

5. Merck repurchased several its own common shares on the open market.
   i. Merck uses the cost method to account for its treasury stock transactions, which means Merck puts the treasury stock on its books at market value at which Merck repurchased it.
   ii. Merck repurchased 26.5 million shares on the open market in 2007.
   iii. Merck paid $1,429,700,000 in total share, $53.95 per share (1,429,700,000/26,500,000), on average to buy back its stock during 2007. This represents the financing portion of a cash flow statement.
   iv. Merck does not disclose its treasury stock as an asset because Merck cannot earn income from its own stock.

6.

In millions	2007	2006
Dividends paid	$(3,307.3)	$(3,322.6)
Shares outstanding	2,172.5	2,167.8
Net income	$3,275.4	$4,433.8
Total assets	$48,350.7	$44,569.8
Operating cash flows	$6,999.2	$6,765.2
Year-end stock price	$57.61	$41.94
Dividends per share	$1.52	$1.53
Dividend yield (dividends per share to stock price)	2.64%	3.65%
Dividends payout (dividends to net income)	1.01	0.75
Dividends to total assets	0.068	0.075
Dividends to operating cash flows	0.473	0.491

Merck's stock price has increased over the past year; however, its net income has decreased by over one million dollars. Merck also saw a decrease in their dividend yield ratio which means the company is receiving a lower return on its investments compared to 2006.

Case 9: Stock Options

1. An employee stock option plan reserves option for future issuance of common shares to employees and directors of the company. This plan gives employees the right to buy a company's stock at a specified "strike price" at a predetermined date in the future, but they are worthless if the stock doesn't reach that price. Stock options are designed to align incentives between the owners and the managers. This gives executives incentive to increase stock price since this will increase the value of the executives' option holdings.

2. Restricted shares give an employee the full value of a company's stock, at a future date, or when a performance goal is reached. These shares cannot be sold until vesting occurs. If an employee leaves the company prior to vesting, they forfeit these shares and they return to the company. Any dividends received from the restricted stock also generally must be repaid to the company. Restricted stock units are simpler and are less risky for employees. For example, Pandora Media Inc. makes stock options available to the company's directors and restricted stocks are for general employees who do not have any control over the company's strategy. This hopefully will encourage employee retention because the employees will be able to count on the restricted stock as a part of his/her compensation.

3. The grant date is the day in which an employee is given a stock option. It is usually later than the date in which it is announced that stock options will be distributed. The exercise price is the price per share at which the owner of a traded option is entitled to buy or sell the underlying security. This is determined at the time the option contract is formed. The vesting period is the time that an employee must wait to be able to exercise employee stock options. The expiration date is the last day that an options or future contract is valid. Stock options are given by a company to an employee to buy stock in the company at a discounted price. Restricted shares of stock are granted after the employee satisfies the vesting requirement, the company allocates the shares or the cash equivalent of the number of shares used to value the shares. Options exercised means the employee purchases the common stock at the price set by the option, regardless of the stock's price at the time they were exercised. An employee may forfeit his/her shares if the employee fails to meet the requirements of the purchase. For example, a stock option might require an employee to stay with the company for 5 years to keep the stock. If the employee leaves the firm before surpassing five years, then the stocks are forfeited.

4. Under Xilinx Inc's ESPP, a qualified employee can obtain a two-year purchase right to buy the company's common stock at the end of every six-month exercise period. The employees are limited to 15% of the employee's yearly earnings up to a maximum of $21 thousand in a calendar year. The

company gives the employees, an incentive to increase stock price and this will then increase the value of the executives' option holdings. If the employees are performing well then, the company's stock itself will be doing well. Advantages of restricted stock are 1. they never become worthless, 2. they result in less dilution to existing stockholders, 3. they better align employee incentives with the company's incentives by providing more of a long-term perspective. For Xilinx, about 78% of all eligible employees participate in the employee stock option plan.

5. Xilinx includes its employee stock purchase plan is included in the computation of stock-based compensation expense. Xilinx uses the straight-line method to recognize the stock-based compensation costs over the period. When the options are exercised, canceled, or expired, deferred tax assets are eliminated for each vesting period on a FIFO basis. The company follows the alternative transition method when calculating the excess tax benefits available. According to GAAP, Xilinx must measure the cost of all employee stock awards that are anticipated to be exercised based on the fair value at the grant date. The company also records that cost as compensation expense during the time the employee is required to perform a service in exchange for the equity award.

6. Xilinx's annual report

   i. Total expense for stock-based compensation for 2013 is $77,569.

ii. Xilinx includes this expense in the General and Administrative expenses for most employees.

iii. The 2013 expense must be added back to net income. The net income account in the Statement of Cash Flows is understated before one adds back this expense. This amount will appear under the operating section.

iv. The company makes it a deferred tax asset and then the company will have a payable. Once the option is exercised the company will pay the payable.

v.

R&D expense	37,937	
COGS		37,937
SG&A expense	33,569	
APIC→S/O		33,569
Deferred tax asset	22,137	
Income tax payable		22,137
W/P inventory	275	
APIC→S/O		275

7. The *Wall Street Journal* article titled, "Last Gap for Stock Options," discusses the falling trend of stock options and the growing use of restricted stock awards. Companies have begun to use more restricted

stock awards because of shareholder demands, changes in the tax law, and the financial crisis. The financial crisis left many high executives in companies with essentially worthless options. Employees and companies in recent years have widely used and supported the use of restricted stock options. They are simpler than stock options and are subject to fewer accounting and tax complications. Restricted stock encourages employees and executives to help the company succeed financially.

8. Over the years, Xilinx has been steadily granting and exercising more restricted shares of stock while also granting and exercising fewer stock options per the trends. In April 2010, Xilinx granted 31,206 shares and in March 2013, Xilinx granted 12,753 shares illustrating a decrease in the use of stock options. However, in April 2010, Xilinx granted 3,652 restricted shares and in March 2013, Xilinx granted 5,996 restricted shares illustrating an increase in the use of restricted stock units.

Case 10: Revenue Cycle

Part I:

1. The Bier Haus has a verbal contract with the student, that the Bier Haus will provide the student with beer if the student pays the designated price for the beer.
2. Once the beer is handed to the student, the Bier Haus has completed the performance obligation of providing the beer to the student.
3. The transaction price is $5.
4. The student hands the Bier Haus employee $5 in exchange for the beer.
5. The Bier Haus recognizes revenue immediately once the student pays for the beer.
    a. Cash 5

       Sales Revenue 5

Part II:

1. The Bier Haus has verbal contract with the student, that the Bier House will provide the student beer and a mug if the student pays the designated price for the beer and the bug.

2. Once the beer in the Ole Miss mug is handed to the student, the Bier Haus has completed the performance obligation of providing the beer and the mug to the student.
3. The transaction price for the beer and the mug is $7.
4. The stand-alone price for the beer is 7*5/8=$4.38, and the stand-alone price for the mug is 7*3/8=$2.62.
5. The Bier Haus recognizes revenue immediately once the student pays for the beer and the mug.
   a. Cash 7

Cash	7	
Sales Revenue-beer		4.38
Sales Revenue-mug		2.62

Part III:

1. The Bier Haus has a verbal contract with the student to provide the student beer in the special mug once the student compensates the Bier House for the beer. The Bier Haus also has a contract with the student that the restaurant will provide a coupon for pretzels if there are no pretzels available. The coupon given to the student is a written contract that once the student once to redeem the coupon, the Bier House will provide the student with two pretzels for $3.50.
2. The coupon has a performance obligation that if the student redeems the coupon at the Bier Haus, the student will receive two pretzels.
3. The transaction price for the beer $5 and $3.50 for the coupon for the pretzels that he can redeem later.

4. The stand-alone price for the beer is 7*5/8.50=$4.12, and the stand-alone price for the coupon is 7*3.50/8.50=$2.88.
5. The Bier Haus recognizes revenue once the student hands over the cash for the coupon and the beer.
   a. Cash 7

Cash	7	
Sales Revenue-beer		4.12
Unearned Revenue-coupon		2.88

Part IV:

1. The Bier Haus has a contract with the student that once the coupon is exchanged the student will receive two pretzels.
2. The coupon has a performance obligation that if the student redeems the coupon at the Bier Haus, the student will receive two pretzels.
3. There is no transaction price because the two parties do not exchange any money.
4. The stand-alone price for the two pretzels in the coupon $3.50.
5. The Bier Haus has already recognized the revenue so there is no journal entry.

Case 11: Deferred Tax Assets and Liabilities

1. Book income is the financial income before taxes or income for financial reporting purposes. ZAGG's book income for 2012 was $23.898 million. Book income is calculated using guidelines provided by GAAP, however, a company's taxable income is calculated after consulting the IRS' tax code. Deduction and exemptions are taken into consideration when a company calculates taxable income.
2. Define the following terms:

   i. A permanent tax difference "results from two items that (1) enter into pretax financial income but never into taxable income, or (2) enter into taxable income but never into pretax financial income" (Kieso, Weygandt, & Warfield, 1066). An example of a permanent tax difference is interest received on state and municipal bonds or the deduction for dividends received from U.S. corporations (recognized only for tax purposes.

   ii. A temporary tax difference is "the difference between the tax basis of an asset or liability and its reported (carrying or book) amount in the financial statements, which will result in taxable amounts or deductible amounts in future years" (Kieso, Weygandt, & Warfield, 1055). An example is a future deductible amount such as depreciation.

   iii. The statutory tax rate is also called the legally imposed tax rate. For example, an income tax can have several statutory tax rates for different income levels, whereas a sales tax might have a flat statutory tax rate. ZAGG's statutory tax rate is 35%.

iv. The <u>effective tax (average rate</u>) is computed by dividing total income tax expense for the period by pretax financial income. ZAGG's effective tax rate is 38%.

3. Most companies will report income taxes as part of its total income tax expense because it provides the clients and the public with a clear picture of all the company's income tax expenses for the year. Deferred income taxes are not the same as a company's total income tax expense, and therefore cannot be combined into one account. Most companies will then defer those taxes to a later year, thus they are not included as a current tax expense.
4. A deferred tax asset is when a business has overpaid taxes or paid taxes in advance on the balance sheet. A deferred tax liability is when there are temporary differences between the estimated taxes payable, the expected income tax rate, and the company's accounting and tax carrying values. A company records a deferred tax asset when "the taxes will be lower in the future," and a company records a deferred tax liability when the taxes will be higher in the future (Kieso, Weygandt, & Warfield, 1055).
5. A deferred income tax valuation allowance is a balance sheet account that counterbalances the value of a company's deferred tax assets because the company does not expect it will be able to realize the full value. A valuation allowance should be recorded when "it is more likely than not that it will not

realize some portion of the deferred tax asset" (Kieso, Weygandt, & Warfield, 1055).

6. Note-8 Income taxes (numbers are in thousands)

   i. Below is the journal entry that ZAGG recorded for the income tax provision in fiscal 2012.

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

   ii. Below is the journal entry that ZAGG recorded to decompose the amount if net deferred income taxes into its deferred income tax asset and deferred income tax liability components.

Income Tax Expense	9,393	
Deferred Tax Asset	8,002	
Deferred Tax Liability		291
Income Tax Payable		17,395

   iii. The effective tax rate is the average rate at which a corporation's pre-tax profits are taxed. To find the effective tax rate a corporation divides the tax expense by the pre-tax income.

Effective tax rate=tax expense/pre-tax income

= 9,393/23,898

=39.3% (2012 effective tax rate for ZAGG)

iv. On ZAGG’s balance sheet, the balance for deferred tax assets is split up in two accounts, current and noncurrent. A section of deferred income tax assets is under current assets for $6,912 and a section of deferred income tax assets is also stated as its own with a balance of $6,596. Both are located on the balance sheet.

Case 12: Leases

1. Leasing assets offer many advantages over owning property such as, 100% financing at fixed rates, protection against obsolescence, flexibility, less costly financing, tax advantages, off-balance-sheet financing.
2. An <u>operating lease</u> is a lease whose term is short compared to the useful life of the asset that is being leased. This type of lease is often used to acquire equipment on a short-term basis. A <u>capital lease</u> is a lease in which the lessor only finances the leased asset, and all other rights of ownership transfer to the lessee. The asset is then classified as a fixed asset in the general ledger. A <u>direct financing lease</u> is a lease that removes the leased asset from its books and replaces it with a receivable from the lessee. The interest received is the only income recognized by the lessor. A <u>sales-type lease</u> is a lease by the lessor when the fair value of the leased property at the start of a lease varies from its carrying amount, it involves real estate, and there is a transfer of ownership to the lessee by the end of the lease term.
3. Accountants distinguish between different types of leases because each lease has different financial and accounting uses, and each type of lease has different requirements. Distinguishing between the different types of leases also give the people a better and more reliable view of the business.
4. Hypothetical Lease

i. The lease will be treated as an operating lease because it does not meet any of the requirements of a capital lease. Capital lease rules are listed below:

   a. The lease transfers ownership of the property to the lessee.
   b. The lease contains a bargain-purchase option.
   c. The lease term is equal to 75% or more of the estimated economic life of the leased property.
   d. The present value of the minimum lease payments equals or exceeds 90% of the fair value of the leased property.

ii.

Rent Expense	100,000	
Cash		100,000

iii. **<u>Year 1</u>**

Rent Expense	100,000	
Deferred Rent Expense		100,000

<u>Year 2-5</u>

Rent Expense	100,000	
Deferred Rent	25,000	
Cash		125,000

5. Analysis of note 10

   i. The amount of rent expense on operating leases in 2009 was $45.9 million.

ii. The rent expense for 2009 appeared in the selling, general, and administrative section under costs and expenses on the consolidated statement of operations.

6. Future Lease Payments

i.

Period	Payments	PV	PV of Payment
1	$50,651	0.9346	$47,337.38
2	$47,107	0.8734	$41,145.08
3	$42,345	0.8163	$34,566.13
4	$35,469	0.7629	$27,059.13
5	$31,319	0.7130	$22,330.01
6	$25,229	0.6663	$16,811.15
7	$25,229	0.6227	$15,711.35
8	$25,229	0.5820	$14,683.51
			$219,643.75

ii.

PPE	219,643.75	
Lease Obligations		219,643

iii.

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

7. Build-A-Bear Workshop, Inc. do not have to report depreciation on their statements because it is an operating lease. The lease expenses are treated as

operating expenses and the operating leases do not show up as part of the capital of the firm.

8. Ratios

   i. The table below illustrates the ratios before 2010 and then the different ratios after January 2, 2010. The current ratio is a liquidity ratio calculated by current assets/current liabilities. The debt-to-equity ratio is used to manage a company's financial leverage and is calculated by total liabilities/shareholders' equity. The long-term debt-to-equity ratio measures the percentage of a company's assets financed with loans lasting longer more than a year. The current ratio, the debt-to-equity ratio, and the long-term debt-to-equity ratio all increased. Capital leases will not always yield weaker liquidity and solvency ratios because it depends on the increase in net assets, net income, and net liabilities.

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