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A Compilation of Case Studies Highlighting Current Issues and Uses of Accounting Methods and Procedures

by

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A thesis submitted to the faculty of The University of Mississippi in partial fulfillment of the requirements of the Sally McDonnell Barksdale Honors College.

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Approved by

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Abstract

Over the course of a year, I have gained significant knowledge of accounting treatments for different situations that may come about in the business world. After working in a real-life setting, I quickly realized how my knowledge of accounting treatments and procedures benefitted me. For my thesis requirement, I have gathered examples from case studies for major accounting topics that are widely-used amongst professionals. Each chapter of my thesis is in case format, mirroring the given format of the cases I have used for my study. Each case presented itself with issues, to which I gave my opinion on how the various situations were to be treated. With help from professors, textbooks, and scholarly and professional research, I was able to make educated opinions and assumptions about the treatments of the items discussed in my compilation of case studies.

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Case Study 1

Home Heaters:

Financial Statement Analysis

1. Executive Summary

Below are financial statements from Glenwood Home Heating, Inc. and Eads Home Heating Inc., respectively. These statements provide information on the overall health and profitability of the companies. It can be concluded by evidence in these statements that Glenwood is the more profitable company of the two, making it more desirable for possible investors.

2. Glenwood Home Heating, Inc.

a. Financial Statements

Glenwood Home Heaters, Inc. Income Statement For Year Ended December 31, 20X1		
Sales		
Sales Revenue		$398,500
Cost of goods sold		$177,000
Gross profit		$221,500
Operating expenses		
Rent Expense	$16,000	
Depreciation Expense - Building	$10,000	
Depreciation Expense - Equipment	$9,000	
Bad Debt Expense	$994	
Other Operating Expenses	$34,200	$70,194
Income from operations		$151,306
Other expenses and losses		
Interest expense		$27,650
Income before income tax		$123,656
Income tax		$30,914
Net income for the year		**$92,742**
Earnings per common share		$21.73

Glenwood Home Heaters, Inc. Balance Sheet As of December 31, 20X1		
Assets		
Current Assets		
Cash		$426
Accounts Receivable	$99,400	
Less: Allowance for bad debts	-$994	$98,406
Inventory		$62,800
Total Current Assets		$161,632
Property, Plant, and Equipment		
Land		$70,000
Building	$350,000	
Less: Acc. Dep: Building	-$10,000	$340,000
Equipment	$80,000	
Less: Acc. Dep: Equipment	-$9,000	$71,000
Total property, plant, and equipment		$481,000
Total Assets		**$642,632**
Liabilities and Stockholder's Equity		
Current Liabilities		
Accounts payable	$26,440	
Interest payable	$6,650	
Total Current Liabilities		$33,090
Long-term Liabilities		
Notes payable	$380,000	
Total Long-term Liabilities		$380,000
Total Liabilities		$413,090
Stockholder's Equity		
Common Stock	$160,000	
Retained Earnings	$69,542	
Total Stockholder's Equity		$229,542
Total Liabilities and Stockholder's Equity		**$642,632**

Glenwood Home Heaters, Inc.

Statement of Cash Flows

For Year Ended December 31, 20X1

Operating		
Net Income		$92,742
Depreciation Expense	$19,000	
Bad Debt Expense	$994	
Accounts Receivable	-$99,400	
Inventory	-$62,800	
Accounts Payable	$26,440	
Interest Payable	$6,650	-$109,116
Cash provided by Operating Activities		**-$16,374**
Investing		
Land	-$70,000	
Building	-$350,000	
Equipment	-$80,000	
Cash used by Investing Activities		**-$500,000**
Financing		
Note Payable	$380,000	
Common Stock	$160,000	
Dividends	-$23,200	
Cash provided by Financing Activities		**$516,800**
Net Cash Flow		**$426**

Glenwood Home Heaters, Inc.

Statement of Stockholders' Equity

For Year Ended December 31, 20X1

	Common Stock	Retained Earnings	Total
Beginning balance	160,000	0	160,000
Net income		92,742	92,742
Dividends		23,200	23,200
Ending balance	160,000	69,542	229,542

b. Analysis

Glenwood Home Heating Inc. has a very strong Net Income of 92,742 dollars. Most of its cash is provided by financing activities, which shows it is active amongst investors. Also, Glenwood's Sales Revenue is more than double the Cost of Goods Sold, which means the company is good at creating profit from their own products.

c. Eads Home Heating, Inc.

a. Financial Statements

Eads Home Heaters, Inc. Income Statement For Year Ended December 31, 20X1		
Sales		
Sales Revenue		$398,500
Cost of goods sold		$188,800
Gross profit		$209,700
Operating expenses		
Depreciation Expense - Building	$10,000	
Depreciation Expense - Equipment	$20,000	
Depreciation Expense - Leased equipment	$11,500	
Bad Debt Expense	$4,970	
Other Operating Expenses	$34,200	$80,670
Income from operations		$129,030
Other expenses and losses		
Interest expense		$35,010
Income before income tax		$94,020
Income tax		$23,505
Net income for the year		**$70,515**
Earnings per common share		$14.79

Eads Home Heaters, Inc. Balance Sheet As of December 31, 20X1		
Assets		
Current Assets		
Cash		$7,835
Accounts Receivable	$99,400	
Less: Allowance for bad debts	-$4,970	$94,430
Inventory		$51,000
Total Current Assets		$153,265
Property, Plant, and Equipment		
Land		$70,000
Building	$350,000	
Less: Acc. Dep: Building	-$10,000	$340,000
Equipment	$80,000	
Less: Acc. Dep: Equipment	-$20,000	$60,000
Leased Equipment	$92,000	
Less: Acc. Dep: Leased Equipment	-$11,500	$80,500
Total property, plant, and equipment		$550,500
Total Assets		**$703,765**
Liabilities and Stockholder's Equity		
Current Liabilities		
Accounts Payable	$26,440	
Interest Payable	$6,650	
Total Current Liabilities		$33,090
Long-term Liabilities		
Notes payable	$380,000	
Lease Payable	$83,360	
Total Long-term Liabilities		$463,360
Total Liabilities		$496,450
Stockholder's Equity		
Common Stock	$160,000	
Retained Earnings	$47,315	
Total Stockholder's Equity		$207,315
Total Liabilities and Stockholder's Equity		**$703,765**

Eads Home Heaters, Inc. Statement of Cash Flows For Year Ended December 31, 20X1		
Operating		
Net Income		$70,515
Depreciation Expense	$41,500	
Bad Debt Expense	$4,970	
Accounts Receivable	-$99,400	
Inventory	-$51,000	
Accounts Payable	$26,440	
Interest Payable	$6,650	-$70,840
Cash provided by Operating Activities		**-$325**
Investing		
Land	-$70,000	
Building	-$350,000	
Equipment	-$80,000	
Cash used by Investing Activities		**-$500,000**
Financing		
Note Payable	$380,000	
Common Stock	$160,000	
Dividends	-$23,200	
Principal on Lease	-$8,640	
Cash provided by Financing Activities		**$508,160**
Net Cash Flow		**$7,835**

Eads Home Heaters, Inc. Statement of Stockholders' Equity For Year End December 31, 20X1			
	Common Stock	Retained Earnings	Totals
Beginning balance	160,000	0	160,000
Net income		70,515	70,515
Dividends		23,200	23,200
Ending balance	160,000	47,315	207,315

b. Analysis

Eads Home Heating Inc. still has a strong Net Income, but it is just a good amount less than Glenwood's. Like Glenwood, Eads takes advantage of its financing capabilities, therefore providing cash for the company. Eads also yields an impressive Gross Profit, showing that they have a suitable business strategy.

d. Comparison & Analysis

Overall, Glenwood is the superior company with regards to Net Income, Gross Profit, and Retained Earnings, which provide key information on a company's health. Eads falls just shortly behind Glenwood with comparably notable numbers in those categories, but Glenwood comes out on top in those major measures. Given this information, I would be more willing to invest money into Glenwood just by looking at their financial statements. Of course each company has its intangible benefits, but Glenwood is clearly the better performer, making it a less risky choice to invest in purely based off of numerical evidence.

e. Appendix A – Glenwood Transactions & Adjusted Trial Balance

Glenwood Home Heaters, Inc.

Adjusted Trial Balance: Part B

As of December 31, 20X1

	Debit	Credit
Cash	426	
Accounts Receivable	99,400	
Allowance for Bad Debts		994
Inventory	62,800	
Land	70,000	
Building	350,000	
Acc. Dep: Building		10,000
Equipment	80,000	
Acc. Dep: Equipment		9,000
Accounts Payable		26,440
Interest Payable		6,650
Note Payable		380,000
Common Stock		160,000
Dividends	23,200	
Sales		398,500
Cost of Goods Sold	177,000	
Other Operating Expenses	34,200	
Bad Debt Expense	994	
Depreciation Expense	19,000	
Rent Expense	16,000	
Interest Expense	27,650	
Provision for Income Taxes	30,914	
	991,584	991,584

Glenwood Home Heaters, Inc.

Part B: Transactions

	Assets									Liabilities			Stockholder's Equity									
Transactions	Cash	Accounts Receivable	Allowance for Bad Debts	Inventory	Land	Building	Accumulated Depreciation - Building	Equipment	Accumulated Depreciation - Equipment	Accounts Payable	Interest Payable	Note Payable	Common Stock	Dividends	Sales	Cost of Goods Sold	Bad Debt Expense	Depreciation Expense	Interest Expense	Other Operating Expenses	Rent Expense	Provision for Income Taxes
Balances Part A	47,340	99,400		239,800	70,000	350,000		80,000		26,440	6,650	380,000	160,000	23,200	398,500				27,650	34,200		
Part B (1) Bad Debts			- 994														994					
Part B (2) COGS				- 177,000												177,000						
Part B (3) Depreciation																						
Building							- 10,000											10,000				
Equipment									- 9,000									9,000				
Part B (4) Equipment Rental	- 16,000																				16,000	
Part B (5) Income Tax	- 30,914																					
Balances	426	99,400	- 994	62,800	70,000	350,000	- 10,000	80,000	- 9,000	26,440	6,650	380,000	160,000	23,200	398,500	177,000	994	19,000	27,650	34,200	16,000	30,914

f. Appendix B – Eads Transactions & Adjusted Trial Balance

Eads Home Heaters

Part B: Transactions

Transactions	Cash	Accounts Receivable	Allowance for Bad Debts	Inventory	Land	Building	Accumulated Depreciation - Building	Equipment	Accumulated Depreciation - Equipment	Leased Equipment	Accumulated Depreciation - Leased Equipment
	Assets										
Balances Part A	47,340	99,400		239,800	70,000	350,000		80,000			
Part B (1) Bad Debts			4,970								
Part B (2) COGS				- 188,800							
Part B (3) Depreciation											
Building							- 10,000				
Equipment									- 20,000		
Part B (4) Leased Equipment											
Lease										92,000	
Lease Payment	- 16,000										
Depreciation											- 11,500
Part B (5) Income Tax	- 23,505										
Balances	7,835	99,400	4,970	51,000	70,000	350,000	- 10,000	80,000	- 20,000		

Transactions	Accounts Payable	Interest Payable	Note Payable	Lease Payable	Common Stock	Dividends	Sales	Cost of Goods Sold	Bad Debt Expense	Depreciation Expense	Interest Expense	Other Operating Expenses	Rent Expense	Provision for Income Taxes
	Liability				Stockholder's Equity									
Balances Part A	26,440	6,650	380,000		160,000	23,200	398,500				27,650	34,200		
Part B (1) Bad Debts									4,970					
Part B (2) COGS								188,800						
Part B (3) Depreciation														
Building										10,000				
Equipment										20,000				
Part B (4) Leased Equipment														
Lease				92,000										
Lease Payment				- 8,640							7,360			
Depreciation										11,500				
Part B (5) Income Tax														
Balances	26,440	6,650	380,000	83,360	160,000	23,200	398,500	188,800	4,970	41,500	35,010	34,200	-	23,505

Eads Home Heaters, Inc.

Trial Balance: Part B

As of December 31, 20X1

	Debit	Credit
Cash	7,835	
Accounts Receivable	99,400	
Allowance for Bad Debts		4,970
Inventory	51,000	
Land	70,000	
Building	350,000	
Acc. Dep: Building		10,000
Equipment	80,000	
Acc. Dep: Equipment		20,000
Leased Equipment	92,000	
Acc. Dep: Leased Equipment		11,500
Accounts Payable		26,440
Interest Payable		6,650
Note Payable		380,000
Lease Payable		83,360
Common Stock		160,000
Dividends	23,200	
Sales		398,500
Cost of Goods Sold	188,800	
Other Operating Expenses	34,200	
Bad Debt Expense	4,970	
Depreciation Expense	41,500	
Interest Expense	35,010	
Provision for Income Taxes	23,505	
	1,101,420	1,101,420

Case Study 2

Income Statement Presentation:

Totz & Doodlez

1. Summary

Totz is a children's store that sells high quality, stylish children's clothes. Fiscal years 2014, 2015, and 2016 have been recorded. In the third quarter of fiscal year 2015, Totz introduced Doodlez, which is an art studio in the store that offers services like painting, pottery, and drawing classes.

Totz was able to gather financial information to include in their income statement, and decided to present it in sections with help from the FASB Codification. The company had a few different options when deciding how to present each item, but following is the way they chose to do it.

2. Income Statement Presentation

a. Net Sales:

Totz reported net sales of $86.5 million in fiscal year 2015, which is a $12 million increase from net sales of $74.5 million achieved in 2015. This increase of sales revenue with the inclusion of Doodlez was greater than ten percent, which by FASB standards (ASC 225-10-S99-2(1)), must be stated in a different in a different line on the income statement than the Totz revenue. Both of these revenues from sold merchandise should be presented in the "Sales" section of the income statement.

b. Gross Profit

Gross profit, which is calculated net sales less cost of sales, is one of the best way to determine the success of a company. Totz showed an increase in gross profit of $2.4 million from $28 million in 2015 to $30.4 million in 2016. Costs of sales also increased directly with gross profit, with a $9.6 million increase from $46.5 million in 2015 to $56.1 million in 2016. Much of this increase is due to Doodlez's services. When recording these amounts, cost of sales is to be split between the different sources of costs, which in this case, are costs deriving from Totz and costs deriving from Doodlez (ASC 225-10-S99-2(2)). These costs are to be recorded in the "Cost of Sales" section of the income statement. It should be clear that depreciation is not included in the cost of sales according to ASC-225-10-S99-8. Gross Profit is equivalent to net sales of both Totz and Doodlez less costs of sales of the same groups.

c. Gain on Sale of Corporate Headquarters

Totz moved their location and ended up selling the building they left behind. They received $1.7 million from the sale and will record this as a gain. According to ASC 225-20-45-4(d) and ASC 225-20-45-5, the gain on this sale should not be classified as an extraordinary item and should be placed into the operating income section of the income statement. It should be placed in operating income since it was an asset used regularly in the business. Gain from sale of property can only be classified as extraordinary if the sale is a result of a natural disaster, an expropriation, or a newly enacted law (ASC 225-20-45-5).

d. Class Action Settlement

A lawsuit with a gain of $2.7 million was settled for Totz in 2016. This value would fall under non-operating income under “Miscellaneous Income”, with disclosure of the nature of the gain in a note (ASC-225-10-S99-2(7d). Normally, contingent gains are not recognized, but in this case, since it is confirmed that Totz received money from the settlement, they will record the gain.

Case Study 3

Rocky Mountain Chocolate Factory: Financial Statements

1. Unadjusted Trial Balance

		Beginning Balance	1. Purchase Inventory	2. Incur Factory wages	3. Sell inventory for cash and on account	4. Pay for inventory	5. Collect receivables	6. Incur SG&A (cash and payable)	7. Pay wages	8. Receive franchise fee	9. Purchase PPE	10. Dividends declared and paid	11. All other transactions	Unadjusted Trial Balance
Dr.	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	0											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
	Other	224,378											-4,215	220,163
	Property and Equipment, net	5,253,598									498,832		132,859	5,885,289
	Notes receivable, less current portion	124,452											139,198	263,650
	Goodwill, net	1,046,944												1,046,944
	Intangible assets, net	183,135											-73,110	110,025
	Other	91,057											-3,007	88,050
Cr.	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					0
	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
	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	0			22,000,000								944,017	22,944,017
	Franchise and royalty fees	0											5,492,531	5,492,531
Dr.	Cost of sales	0			14,000,000								693,786	14,693,786
	Franchise costs	0											1,499,477	1,499,477
	Sales & marketing	0						1,505,431						1,505,431
	General and administrative	0						2,044,569					-261,622	1,782,947
	Retail operating	0						1,750,000						1,750,000
	Depreciation and amortization	0												0
	Interest income	0											-27,210	-27,210
	Income tax expense	0											2,090,468	2,090,468
	A= L + OE + R - E	0	0	0	0	0	0	0	0	0	0	0	0	

2. Adjusted Trial Balance

		Unadjusted Trial Balance	12. Adjust for inventory count	13. Record depreciation	14. Wage accrual	15. Consultant's report	Pre-closing trial balance	16. Closing entry	Post-closing (ending) balance	Actual February 28, 2010 F/S figures
Dr.	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
	Other	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 portion	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	88,050					88,050		88,050	88,050
Cr.	Accounts payable	877,832					877,832		877,832	877,832
	Accrued salaries and wages	0			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
	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	0	22,944,017
	Franchise and royalty fees	5,492,531					5,492,531	-5,492,531	0	5,492,531
Dr.	Cost of sales	14,693,786	216,836				14,910,622	-14,910,622	0	14,910,622
	Franchise costs	1,499,477					1,499,477	-1,499,477	0	1,499,477
	Sales & marketing	1,505,431					1,505,431	-1,505,431	0	1,505,431
	General and administrative	1,782,947			639,200		2,422,147	-2,422,147	0	2,422,147
	Retail operating	1,750,000			6,956		1,756,956	-1,756,956	0	1,756,956
	Depreciation and amortization	0		698,580			698,580	-698,580	0	698,580
	Interest income	-27,210					-27,210	27,210	0	-27,210
	Income tax expense	2,090,468					2,090,468	-2,090,468	0	2,090,468
	A= L + OE + R - E	0	0	0	0	0	0	0	0	

3. Income Statement

Rocky Mountain Chocolate Factory, Inc.		
Income Statement		
For Year Ended February 28, 2010		
Revenues		
Sales		$ 22,944,017
Franchise and royalty fees		5,492,531
Total revenues		28,436,548
Costs and Expenses		
Cost of sales		14,910,622
Franchise costs		1,499,477
Sales & marketing		1,505,431
General and administrative		2,422,147
Retail operating		1,756,956
Depreciation and amortization		698,580
Total costs and expenses		22,793,213
Operating Income		5,643,335
Other Income (Expense)		
Interest expense		0
Interest income		27,210
Other, net		27,210
Income Before Income Taxes		5,670,545
Income Tax Expense		2,090,468
Net Income		$ 3,580,077
Basic Earnings per Common Share		$ 0.60
Diluted Earnings Common Share		$ 0.58
Weighted Average Common Shares Outstanding		6,012,717
Dilutive Effect of Employee Stock Options		197,521
Weighted Average Common Shares Outstandin Assuming Dilution		6,210,238

4. Statement of Retained Earnings

Rocky Mountain Chocolate Factory, Inc.		
Income Statement		
For Year Ended February 28, 2010		
Beginning Retained Earnings		3,343,850
Net Income		3,580,077
Dividends		0
End Retained Earnings		6,923,927

5. Balance Sheet

Rocky Mountain Chocolate Factory, Inc.		
Balance Sheet		
As of February 28, 2010		
Assets		
Current Assets		
Cash and cash equivalents		$ 3,743,092
Accounts receivable		4,427,526
Notes receivable, current		91,059
Inventories		3,281,447
Deferred income taxes		461,249
Other		220,163
Total current assets		12,224,536
Property and Equipment, Net		5,186,709
Other Assets		
Notes receivable, less current portion		263,650
Goodwill, net		1,046,944
Intangible assets, net		110,025
Other		88,050
Total other assets		$ 1,508,669
Total assets		$ 18,919,914
Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts payable		$ 877,832
Accrued salaries and wages		646,156
Other accrued expenses		946,528
Dividend payable		602,694
Deferred income		220,938
Total current liabilities		3,294,148
Deferred Income Taxes		894,429
Commitments and Contingencies		
Stockholders' Equity		
Common stock		180,808
Additional paid-in-capital		7,626,602
Retained earnings		6,923,927
Total stockholders' equity		14,731,337
Total liabilities and stockholders' equity		$ 18,919,914

6. Cash Flow Classification

Balance Sheet Accounts			
	Operating	Investing	Financing
Assets			
Current Assets			
Cash and cash equivalents			
Accounts receivable	X		
Notes receivable, current	X		
Inventories	X		
Deferred income taxes	X		
Other			
Total current assets			
Property and Equipment, Net		X	
Other Assets			
Notes receivable, less current portion			X
Goodwill, net			
Intangible assets, net			
Other			
Total other assets			
Total assets			
Liabilities and Stockholders' Equity			
Current Liabilities			
Accounts payable	X		
Accrued salaries and wages	X		
Other accrued expenses	X		
Dividend payable	X		
Deferred income	X		
Total current liabilities			
Deferred Income Taxes	X		
Stockholders' Equity			
Common stock			X
Additional paid-in-capital			X
Retained earnings			X
Total stockholders' equity			

Income Statement Accounts			
	Operating	Investing	Financing
Revenues			
Sales			
Franchise and royalty fees			
Total revenues			
Costs and Expenses			
Cost of sales			
Franchise costs			
Sales & marketing			
General and administrative			
Retail operating			
Depreciation and amortization	X		
Total costs and expenses			
Operating Income			
Other Income (Expense)			
Interest expense			
Interest income			
Other, net			
Income Before Income Taxes			
Income Tax Expense			
Net Income	X		

Case 4

Cash/Receivables: Examining Potential Fraud Schemes and Internal Control Procedures

Summary:

As the owner of a small craft shop in Oxford, Mississippi, Ms. Kayla Stevens faces the possibility that fraud schemes are occurring at her local business. To safeguard the craft shop's operations, Kayla should implement internal control systems, which include checks and balances created to prevent and detect fraud. Table 4-1 identifies various fraud schemes and recommends internal control procedures to protect the business.

Table 4-1 Analyzing Fraud Schemes and Internal Control Procedures

Fraud Scheme	Internal Control
Lucy may understate or not record sales as she has the power to both record sales and prepare bank deposits. Thus, Lucy could understate sales and pocket cash that she does not include with the bank deposits.	Separation of duties – Kayla should separate the responsibilities for receiving, depositing, recording, and reconciling cash so that an employee cannot both commit and conceal fraud. Clerks should collect cash during sales. A different individual should record daily sales, and Lucy may prepare bank deposits.
Kayla takes deposits to the bank and reconciles bank statements. This current system allows for embezzlement.	Separation of duties – While dividing all responsibilities may be difficult since the business is small, separation of duties provides greater internal control. One person should take deposits to the bank, and Kayla can reconcile bank statements.
Inventory purchases could be fraudulent since Kayla pays bills and also monitors, records, and orders inventory. One could order inventory but then keep it for personal purposes instead of recording it in the inventory account. One could also write fraudulent checks for fake invoices.	Separation of duties – One clerk will order inventory with Kayla's authorization, and another clerk will record the inventory once it arrives in the store. Then, Kayla can pay invoices. Thus, no one has enough power to steal inventory and hide such behavior in the records.
Clerks may input fake or inaccurate transactions as they have authority for entering all types of transactions in the registers. The shop's new coupon program may allow clerks to enter false discounts and pocket the difference between the money collected and the sale recorded.	Access control – The types of transactions clerks can enter should be restricted, and employees should receive authorization before they can issue a refund or enter any irregular transaction into the cash register. This internal control should limit a clerk's ability to record an erroneous sale.
The clerks' unlimited authority in entering transactions also allows Amanda, Becca,	Access control – Clerks should not remove cash without authorization. Requiring unique codes to use the register allows

Sam, or Wendy to steal cash directly from the cash register.	employee activity to be tracked, and Kayla should require the reconciliation of cash to check that the amount of cash on hand matches the receipts. To find a culprit, Kayla can give employees vacation and see if cash discrepancies continue or end during a particular employee's time off.
The credit card machine is behind the cash registers. Clerks may steal credit card information or perform fraudulent actions since customers cannot see that their credit card transactions are performed correctly.	Physical control – Kayla should relocate the credit card machine next to the cash registers to ensure that the credit card is swiped and that the transaction is properly completed at the correct price.
The amount recorded for sales or cash earned may be manipulated or presented inaccurately as the store's information system automatically updates inventory accounts while Lucy manually records sales in the accounting software.	Application and access control – Kayla can consider purchasing more sophisticated software that automatically records sales to prevent manipulation of data. If Lucy must enter sales manually, an access control should limit her access to other parts of the accounting software.
If transactions have no identification number or if register tape is not compared to the amount of sales journalized, Lucy or clerks can alter transactions without any matching supplemental records, and their actions will go unnoticed.	Application control – Kayla should use software that indexes each sale with details like the transaction number, date, amount, and clerk's name. This internal control provides unaltered evidence of sales for audits and allows the actual cash balance to be reconciled to the register tape's sales.
Lucy's locked office may allow her to operate in secret.	Physical control – Any business space is property of the business, and Kayla needs a key to Lucy's office to discourage any unauthorized actions. Kayla should keep a safe in her locked office for security.
Kayla has control of all other accounting functions, so she has the ability to commit fraud schemes such as embezzlement, misrepresenting net income, and stealing inventory.	Independent verification – Kayla should consider using an objective accountant to ensure the integrity of financial records. For example, a physical inventory count by external and internal parties can reconcile perpetual inventory records with the true amount of product sold.

Case Study 5

Inventory Analysis

Summary:

A company is looking to analyze the effects of obsolete and/or unmarketable inventory on their financial statements and on the health of their company. In many companies, inventory makes up a bulk of assets, so companies have to strategically and efficiently manage their inventory. Three categories of inventory are involved, but the main category that can be affected by becoming obsolete is the finished goods inventory. Companies must find ways to decrease obsolete inventory to make sure their finished goods are able to be purchased by customers.

1. **Raw Materials** – Procurement/purchasing from supplier, storage

   Work-in-process – Direct/indirect labor, direct/indirect materials, factory overhead, materials/equipment used for production, storage

   Finished Goods – Shipping costs, storage, packaging

2. Inventories are net of an estimated allowance for obsolete or unmarketable inventory.

3. **a.** Balance Sheet

   b. 2012 gross inventory: $198,386

   2011 gross inventory: $219,722

c. Most, if not all, of the reserve for obsolete inventory should be allocated to finished goods because there is a higher change that inventory in this category has gone astray in some way. Also, a small amount could be attributed to raw materials for materials that are unusable. Work in process is unlikely to have a reserve for obsolete because labor and overhead are unlikely to become obsolete.

4. Cost of goods sold 13,348

Allowance for obsolete and unmarketable inventory 13,348

Allowance for obsolete and unmarketable inventory 13,348

Finished goods inventory 13,348

5.

Raw Materials

46,976 438,561 (d)	442,068
$43,469	

Work-In-Process

1,286 442,068 (c) 126,000	568,735
$619	

Finished Goods, net

184,808 568,735 (b)	13,348 572,549 (a)
$167,646	

Cost of Sales

0 13,348 572,549	
$ 585,897	

Accounts Payable

443,772 (e)	72,465 438,561
	$67,254

6. Inventory Turnover Ratio = $\frac{585{,}897}{(211{,}734+268{,}591)/2}$ = 2.44

7. Inventory Holding Period = $\frac{365}{2.44}$ = 149.62

On average, the company took about 150 days to manufacture and sell its inventory. The company is becoming more efficient in managing its inventory.

8. An estimate of the amount of obsolete inventory in finished goods is around 8%.

As an investor or analyst, I would like to know the prior year's percentage of obsolete inventory to see if the company is increasing the quality of their inventory.

Case Study 6

WorldCom Inc.: Capitalized Costs and Earnings Quality

1.

- **a.** SCON 6, by my interpretation, defines assets as something a company holds from a past event that is able to produce benefit for the company in some way in the near or far future (CON 6-1). SCON 6, by my interpretation, defines expenses as the using up of either assets or liabilities due to ongoing operations of the company. These are costs that a company incurs regularly in order to do day-to-day business (CON 6-2).
- **b.** Costs should be expensed when they are part of ongoing activities for a company. Costs should be capitalized as assets when they have a future benefit associated with them.

2. Net income on the income statement will initially be higher because costs are not being recorded as expenses, therefore understating expenses. On the balance sheet, assets and equity will be higher after initial capitalization.

3.

	Debit	Credit
Line Costs (Expense)	14,739,000,000	
Cash		14,739,000,000

These "line costs" are the charges from the telephone provider that account for phone usage for the company.

4. The types of cost that were improperly capitalized by WorldCom were expenses, specifically, changes paid to telephone networks. These types of costs are

supposed to be allocated to operating expenses, therefore should not be capitalized. This money-saving decision made by Sullivan was led by thinking that the costs could be spread out over time, rather than accounted for as expenses. His decision blatantly violated accounting rules in the fact that ongoing costs such as phone line costs are to be expensed, rather than capitalized like long term investments. These line costs do not meet the definition of assets given by the SCON 6.

		Debit	Credit
5.	PPE (Asset)	3,055,000,000	
	Line Costs (Expense)		3,055,000,000

These appear on the balance sheet under property, plant, and equipment. They would appear on the statement of cash flows under the investing section.

		Debit	Credit
6.	Depreciation Expense	83,306,818	
	Accumulated Depreciation		83,306,818

7.	Income before taxes, as reported	$ 2,393,000,000
	Add: Depreciation for the year	83,306,818
	Less: Line costs improperly capitalized	(3,055,000,000)
	Loss before taxes, restated	(578,693,182)
	Add: Income tax benefit	202,542,614
	Add: Minority interest	35,000,000
	Net loss, restated	$ (341,150,568)

The difference in net income is very material.

Appendix

Part F: Depreciation Expense Calculation

Quarter 1: (771,000,000/22) *(4/4) = 35,045,455

Quarter 2: (610,000,000/22) *(3/4) = 20,795,455

Quarter 3: (743,000,000/22) *(2/4) = 16,886,364

Quarter 4: (931,000,000/22) *(1/4) = 10,579,545

Total Depreciation for the Year 83,306,818

Case Study 7

Targa Company: Business Line Restructure

1. Executive Summary

Restructuring a business comes with many complications for a company. Before deciding to restructure, a company must consider the many costs included like termination of employees, relocation, and retraining. FASB Codification classifies this kind of business decision as "an exit activity which includes but is not limited to a restructuring, such as the sale or termination of a line of business, the closure of business activities in a particular location, the relocation of business activities from one location to another, changes in management structure, and a fundamental reorganization that affects the nature and focus of operations." Under this FASB definition, there are also guidelines provided by the FASB Codification under this umbrella when accounting for a restructure." (ASC 420-10-15-4).

2. Employee Benefits

In order to most efficiently use its resources for restructuring a business line, Targa Company must downsize its workforce. By doing this, they must cut down their employees by ten percent. Upon their involuntary termination, employees are entitled to a good amount of compensation from the company. Employees will only receive this benefit if they work until the date that Targa quits production for that line of service. This standard is not just company policy for Targa, but it is a required method of recording compensation benefits by FASB. In the Codification, FASB states that "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" (ASC 420-10-30-6).

Targa Company also issued a statement that this termination of employees is a one-time occurrence, meaning that employees will not be terminated in waves, but rather at just one time. The company decided to terminate employees all at one time most likely due to the circumstances of shutting down a facility that hosted the discontinued business line. Upon this termination of employees, there must be several guidelines that need to be followed in order to align with FASB standards. According to FASB, "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 on the communication date." (ASC 420-10-25-4).

Criteria for one-time employment termination benefits includes:

"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." (ASC 420-10-25-4).

These post-employment benefits do not come without a loss for the company. Upon the communication date of the termination, Targa Company must know how to correctly account for the cost of the benefits. Benefits given by the company like bonuses and wage compensation have monetary value that needs to be recognized. FASB has communicated that "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." (ASC 712-10-25-1). As a result of these standards, a liability must be recognized on the balance sheet on December 27, 20X1, and a loss recorded on the income statement for year ended December 31, 20X1.

3. Retraining and Relocation Costs

Along with the employee termination benefits discussed above for the circumstance of restructuring a business line, there are other expenses that go along with them. These income statement items include relocation costs and retraining costs, which fall under the category of start-up costs. Even though the company is not new, these expenses can be

considered start-up costs because a completely new facility is being opened up with new employees who will need to be trained. Since these items must be accounted for in the financial statements, FASB has issued a standard about how to account for start-up costs. According to the FASB Codification, “Costs of start-up activities, including organization costs, shall be expensed as incurred.” (ASC 720-15-25-1). Because of this, these expenses must go on the balance sheet as of December 27, 20X1, and on the income statement for year ended December 31, 20X1.

Because restructuring a business line can be very complicated for a company, start-up costs for a new facility could potentially include more than just retraining and relocation. As given as an example by FASB in the codification, some costs that might be incurred as well as explicit start-up costs could potentially include and not restricted to:

“a. Salary-related expenses for new employees
b. Salary-related expenses for the management store opening team
c. Training costs and meals for newly hired employees
d. Hotel charges, meals, and transportation for the opening team
e. Security, property taxes, insurance, and utilities costs incurred after construction is completed
f. Depreciation, if any, of new computer data terminals and other communication devices
g. Nonrecurring operating losses.” (ASC 720-15-55-6).

Specifically, in this situation, items “c.” and “e.” are being referred to directly in Targa’s costs of restructuring the business in a new location. Not to say that the expenses mentioned above will not be significant, but these two items are large components in Targa’s restructuring costs.

Case Study 8

Merck & Co., Inc. Stockholders’ Equity

Part A

i. Common shares authorized to issue – 5,400,000,000

ii. Common shares issued at 12/31/2007 - 2,983,508,675

iii. 2,983,508,675 x .01 = 29,835,086.75

iv. 811,005,971 treasury stock

v. 2,172,502,884 shares outstanding

vi. Market capitalization = 2,172,502,884 x $57.61 = 125,157,891,147

Part C

i. Companies pay dividends as an incentive for shareholders to keep investing in their company. It also says that a company is not risky to invest in because they are able to afford to pay their shareholders. Share price is expected to go down when dividends are paid.

Part D

i. There are many reasons why a company would repurchase their own shares. One might be to provide stock for employee stock compensation plans. Another reason might be to create artificial demand, making the market look better for the company. Companies might also do this to increase their EPS.

Part E

i. Retained Earnings 3,310,700,000

Dividends Payable 3,400,000

Cash 3,307,300,000

Part G

i. Cost Method

ii. 26,500,000

iii. 1,429,700,000 total; .0185 per share; financing cash flow

iv. Treasury stock is treated as a contra equity item, and they don't gain any future benefit from treasury stock since they are not earning income from their own shares.

Part I

	2007	**2006**
Dividends Paid	3,307,300,000	3,322,600,000
Shares Outstanding	2,172,502,884	2,167,785,445
Net Income	3,275,400,000	4,433,800,000
Total Assets	48,350,700,000	44,569,800,000
Operating Cash Flows	6,999,200,000	6,765,200,000
Year-end Stock Price	$57.61	$41.94
Dividends Per Share	1.52	1.53
Dividend Yield	0.026	0.036
Dividend Payout (dividends paid/NI)	1.01	0.75
Dividends to Total Assets (dividends paid/total assets)	0.068	.075
Dividends to Operating Cash Flows (dividends paid/operating cash flows)	.472	.49

Merck's dividend-related ratios across the two years are typically decreasing except for dividend payout.

Case Study 9

Xilinx Inc.;

Stock Option Accounting

Part A

A stock option gives the holder the right to purchase a share of common stock at a pre-set price. If the stock option never reaches the pre-set price, it will be worthless. However, if the stock price goes above the threshold of the stock option, it can make people considerably wealthy. The largest incentive for stock option plans is to keep upper-level executives wanting to increase the stock price. This means that it will motivate the employees to perform better in order to raise the stock price, because in the end, they will get paid in the amount their stock performs.

Part B

Compared to regular stock options, restricted stock options are simpler because they are subject to less accounting and tax policies. Companies have gotten used to accounting between regular options and RSU's. Restricted shares cannot be sold until vesting occurs. Some advantages of using RSUs over regular options is that it never becomes completely worthless, it results in less dilution, and it better aligns employee incentives with the company's incentives. Companies would use both RSUs and stock options to support different levels of employees' needs and motivators. Restricted stock is also a less risky investment than just a regular stock option.

Part C

Grant date – A grant date is the first day of the offering period for the stock option.

Exercise price – The set price of a common share that a holder has the right to purchase as a stock option.

Vesting period – The vesting period is the time between the grant date and vesting date.

Expiration date – The expiration date is the month the contract expires. More specifically, it is usually the third Friday of the month the contract expires.

Options/RSUs granted – Options/RSUs granted are the amount of options are RSUs that have been requested and issued

Options exercised – Options exercised means that the person who was granted the option is putting to use the rights specified in the contract regarding the option. Options are not always exercised due to market conditions.

Options/RSUs forfeited or cancelled – An option/RSU forfeited is when the "owner fails to meet the purchase requirements which might include paying the money owed or avoiding the selling or transferring of shares during a restricted period. When it is forfeited, she shares becomes the property of the issuing company." (http://www.investopedia.com/terms/f/forfeited-share.asp)

Part D

With the company's employee stock purchase plan, employees are able to obtain a twenty-four month right to purchase common stock shares at the end of every six-month exercise period. An employee would want to participate in this option in the case that the stock price rises above the price that it normally sells for. An example of an incentive for employee stock purchase plans is that they can gain incentive for performing well in the company. These incentives are specifically tailored to the ordinary employees of the company, rather than the higher executives since these two categories of employees typically have different agendas. Also, employee stock purchase plans give employees security in their compensation and give them a chance to earn a higher income.

Part E

Accounting for stock options required the measurement of the cost of employee equity that is to be exercised to the fair value of awards. It is to be recorded as a compensation expense during the service period (vesting period). The company must also record to compensation expense the outstanding, unvested portion of the awards. Cash flows from excess tax benefits must be included in the financing section of the Statement of Cash Flows. The exercise price of the stock options must be equal to the current market price of the common stock. The expense for the stock option plan is to be included in overall compensation expense.

Part F

i. Total expense for stock-based compensation = 77,862

ii. Xilinx includes this expense in the General & Administrative expenses for most employees, but it could also be included in Cost of Goods Sold for employees that are directly related to inventory.

iii. The 2013 expense must be added back to Net Income; the net income on the Statement of Cash Flows is understated before this. This amount appears in the Operating section.

iv. The income tax effect for stock-based compensation is to make it a deferred tax asset, paying it like a prepaid asset. The company will have a payable and pay it when the option is exercised.

v.

Account	Debit	Credit
COGS	6,356	
R&D Expense	37,937	
SG&A Expense	33,569	
APIC – Stock Option		77,862

Account	Debit	Credit
Deferred Tax Asset	22,137	
Income Tax Payable		22,137

Part I

i. Restricted stock awards are becoming the new trend in the use of employee stock options. Employees are wanting to use restricted stock instead of regular stock options because their return is more certain in comparison to stock options. In recent years, companies have found restricted stock to be more attractive because it is simpler to account for, while at the same time being a worthwhile type of compensation that encourages growth in the company. For regular employees, the restricted stock option is more attractive than regular stock because it involves less risk. With restricted stock, an employee can count on the amount of their compensation instead of just hoping the market does well.

ii. According to the footnotes in Xilinx's statements, the trend of using restricted stock according to the article is inconsistent with Xilinx's policies. Xilinx utilizes "incentive stock options, non-qualified stock options, and RSUs" (FN pg. 61). In the footnote on page 62, the company states that, "new shares are issued upon employees' exercise of their stock options" in regard to stock option compensation. On page 63, Xilinx reported that "RSUs with a fair value of $40.8 million were vested during fiscal 2013". According to the footnote on page 61, stock options were granted just about as frequently as RSUs were.

Case 10

Revenue Recognition

Part I

Step 1: Identify contracts with a customer: In this particular case, a contract is established when the customer offers the bartender a $5 bill in exchange for a beer. In order for there to be a contract, there must be at least two parties, both exchanging something of consideration. The amount of what is to be consideration can vary by the nature of the contract.

Step 2: Identify the performance obligations: In order for the bartender to receive money from the customer, he must give a beer in exchange for the $5 bill. Vice versa, the customer must give the bartender a $5 bill in order to receive the beer.

Step 3: Determine the transaction price: The transaction price in this contract is $5.

Step 4: Allocate the transaction price to the performance obligations in the contract: The price of the beer is equal to the money paid, which in this case is $5.

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation: The contract is completed when the customer receives the beer after he/she has handed the money to the bartender. This happens instantaneously.

Journal Entry:

Cash	5.00	
Sales Revenue		5.00

Part II:

Step 1: Identify contracts with a customer: The customer must receive the beer and the mug in exchange for cash with the bartender.

Step 2: Identify the performance obligations: The customer must give the bartender $7 for the beer and the mug, and the bartender must give the customer the beer and the mug in exchange for the $5.

Step 3: Determine the transaction price: The entire transaction price is $7.

Step 4: Allocate the transaction price to the performance obligations: Since there are standalone items involved in the transaction, the final transaction price must be allocated to each item. For instance, the transaction price is $7, which the beer and mug standalone prices total to $8. These individual prices must be allocated based on their percentages and multiplied by the transaction price.

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation: The revenue is recognized when the customer receives the beer and mug.

Journal Entry:

Cash	7.00	
Sales Revenue – Beer		4.375
Sales Revenue – Mug		2.625

Part III

Step 1: Identify contracts with the customer: The bartender must give the beer and pretzel coupons (which will eventually turn into tangible goods) to the customer, and the customer must give the bartender money for the goods.

Step 2: Identify the performance obligations: The performance obligation of the customer is to pay the bartender, which he has done. The obligation isn't satisfied on the bartender's end until the coupons are redeems for the two pretzels, but the bartender has satisfied part of his obligation by delivering the beer.

Step 3: Determine the transaction price: The transaction price of this sale is $7.

Step 4: Allocate the transaction price to the performance obligations: The customer pays that bartender $7 in cash, and this amount must be allocated to each individual item. The beer and pretzel coupons were allocated by percentage out of the total amount of $8.50 which includes standalone prices for beer and pretzel coupons. These percentages were then multiplied by $7, the amount that the customer paid for the goods.

Step 5: Recognize revenue when (or as) the entity satisfies the performance obligation: The revenue from the beer will be recognized when the customer receives the beer, but the revenue from the pretzel coupons will not be recognized until the customer actually received the pretzels. For now, it will be recognized as a liability.

Journal Entry:

Account	Debit	Credit
Cash	7.00	
Sales Revenue - Beer		4.12
Unearned Sales Revenue – Pretzel Coupon		2.88

Part IV

Step 1: Identify the contracts with the customer: The customer must give the coupon to the bartender in exchange for the pretzels. On the other end, the bartender must accept the coupon and hand the customer the pretzels because the customer has already paid.

Step 2: Identify the performance obligations: The customer must hand the bartender the coupon in order to receive the pretzel. In turn, the bartender must hand the customer the pretzel in exchange for the pretzel.

Step 3: Determine the transaction price: The transaction price is the coupon itself, which has a value of $3.50. This amount, however, has already been accounted for at the allocated price of $2.88.

Step 4: Allocate the transaction price to the transactions: The transaction price has already been allocated to the books in Part 3.

Step 5: Recognize revenue when (or as) the entity satisfies the performance obligation: Revenue from the transaction is recognized when the coupon is exchanged for the pretzel.

Unearned Revenue – Pretzel Coupon	2.88	
Sales Revenue – Pretzel Coupon		2.88

Case Study 11

ZAGG Inc.

Deferred Income Tax

Part A

The term "book income" simply means the income from items reported on the income statement that are not part of taxable income. If a company can do this accurately, it is completely legal and recognized by the IRS. Examples of non-taxable items include but are not limited to tax refunds, municipal bonds, and worker's compensation. There are sometimes differences in taxable net income and book income because of these situations where companies are allowed to exempt expenses from their taxes. The number that catches this notion in ZAGG's statement of operation is 23,898, which represents the income before taxes are considered.

Part B

i. Permanent tax differences – These differences represent the types of income that are deducted from taxes. A company would show these amounts on both the financial statements in the net income total and on the tax return to the IRS. An example of a permanent tax difference is, as mentioned above, tax-exempt items like federal tax refunds and worker's compensation.

ii. Temporary tax differences – Temporary differences, also known as timing differences, are considered temporary because the amounts reported on the financial statements are not the full amount, making the totals between taxable and book income different. An example of a temporary difference would be accelerated depreciation. In this situation, a company will accelerate their depreciation on their taxes, but not on their own financial statements. Since depreciation can be computed in different ways, the depreciation must be calculated and reported until the whole asset is depreciated. If not done with straight line method, companies will report different amounts each year for depreciation on their taxes and financial statements.

iii. Statutory tax rate - The statuary tax rate is the legally imposed tax rate. This tax rate is stated by the government, and is a law that taxpayers must follow. All entities must succumb to this tax rate since it is put in place by the federal government.

iv. Effective tax rate – The effective tax rate is the rate at which and individual or corporation is taxed. This rate is multiplied by the pre-tax income to get the total net income for the period. This rate is subject to change with the market. The effective tax rate is also the more widely-known rate that is attached to most securities.

Part C

A company would report their deferred income taxes as part of their total income tax expense because the amount that the company owes is in the expense account. While there is a simple expense account, deferred income taxes can be split into two types: deferred tax assets and deferred tax liabilities. Because their names match their functions (assets and liabilities), these two tax accounts function in different ways to the company. It is inaccurate to consider either of these types as simple expenses because they do not function as expenses. Also, they have difference normal balances so they both will not be able to be put into an expense account. For example, if a DTR was put into an income tax expense account, that would be improper accounting because an expense account's normal balance is a debit, which the liability account's normal balance is a credit. These accounts must be totaled on the debit side with the income tax expense to equal the credit side of the income taxes payable account in order to be properly balanced.

Part D

Deferred tax assets represent the amount of taxes that have been paid in advance by a company. A comparison to this treatment is prepaid rent, where the individual pays in advance to the creditor, therefore having less to pay at a later date when it is actually due. An example of a deferred tax asset is when a loss is carried over to the next period because by recognizing the loss, they are lowering their taxable income, and in turn making taxes lower. Deferred tax liabilities are the differences between the accounting and tax numbers reported. By stating that there is a deferred tax liability, the company is realizing the amount of taxes they will have to pay in the future due to a transaction in process. An installment sale receivable would be an example of a deferred tax liability. In this case, the receivable should be recognized when the cash is paid, but the company is already recognizing the taxes it will have to pay because of this transaction ahead of time.

Part E

A deferred income tax valuation allowance is an account that offsets a portion of a company’s deferred tax assets if a company doesn’t think that they will be able to realize the value. This treatment should be used if the creditor believes that the debtor is not going to be able to pay a portion of their taxes (usually 50% probability). Changes to this account are the be included as a reduction from income from continuing operations. This account works like an allowance for doubtful accounts when a company isn’t able to pay its receivables.

Part F

i. Income Tax Expense 9,393

Net Deferred Tax Asset 8,293

Income Tax Payable 17,868

ii. Income Tax Expense 9,393

DTA 8,002

DTL 291

Income Tax Payable 17,868

iii. ETR = 39.3%

iv. Deferred income tax assets = 6,912

Deferred income tax assets = 6,596

Case Study 12

Build-A-Bear Workshop, Inc.:

Capital and Operating Leases

Part A

Companies lease assets rather than buy them for a number of reasons. First, leases can be tax deductible. A company wants to cut their expenses wherever they can, so if they can cut out a chunk of taxes that they would otherwise be paying, they will do it. Next, leases offer flexibility that might not otherwise be offered in a typical buy-sell contract. Also, leases are a very common in today's consumer world. Most things that can be considered major purchases can also be leased. Finally, leases provide immediate access to the asset being leased as opposed to possibly waiting for a loan to go through.

Part B

For a lease to be considered for capitalization, a lease must be noncancelable and meet at least one of the following criteria:

- Transfers ownership of the property to the lessee
- Contains a bargain-purchase option
- Equal to 75% or more of the estimated economic life of the leased property
- Present value of the minimum lease payments equals or exceeds 90% of the fair value of the leased property

Operating Lease – An operating lease is a lease that does not meet any of the above criteria. In this type of lease, expenses are recognized instead of assets and liabilities. In this type of lease only the periods benefitted are recorded, and not periods in the future.

Operating leases can be noncancelable as well as capital leases, and in this case, the lessee must disclose all operating leases that have terms in excess of a year.

Capital Lease – A capital lease is a lease that is noncancelable and meets **at least one** of the following criteria above. When recording this type of lease, amounts in asset and liability accounts are recorded. Depreciation and interest must also be accounted for in a capital lease situation. By using this type of lease instead of an operating lease, the following effects can occur

- Increased debt
- Increased total assets
- Lower income early in the lease's life, leading to lower retained earnings

Direct-Financing Lease – A direct-financing lease is a lease where lessor accounts for the income from the sale over time as the lease payments are made. When an asset is leased, it is replaced with a receivable of some kind. The lessor takes interest from the receivable as its revenue. This kind of lease acts as a loan more so than a standard lease. Profit from this type of lease is recorded at the inception of the lease.

Sales-type Lease – a sales-type lease is a lease where the present value of minimum lease payments is higher than the carrying amount of the asset. In this type of lease, the income that is earned is interest, and profit is recorded as the difference between the minimum lease payments and the carrying amount of the asset. No profit is recorded at the beginning of the lease as opposed to the direct financing lease.

Part C

Accountants distinguish between different types of leases because each type of lease has a different purpose and treatment in regards to the business and financial statements. By knowing how to distinguish between leases, the accountant will know the flow of business better, therefore knowing how to account for the rest of their expenses, assets and liabilities more accurately. The way a company accounts for their leases can also have a dramatic effect on their financial statements, as elaborated on in Part B. Because of this, accountants need to know the best way to classify each lease.

Part D

i. This will be treated as an operating lease because of several conditions. First, the title is not being transferred to the lessee. Also, the lease payments do not exceed 90% of the fair value.

ii.

Account	Debit	Credit
Rent Expense	100,000	
Cash		100,000

iii.

Account	Debit	Credit
Rent Expense	100,000	
Deferred Rent	25,000	
Cash		125,000

Part E

i. The amount of rent expense on operating leases in Fiscal 2009 is 46.8 Million. This amount is attained by adding the rent expense and the contingent rents numbers together.

ii. The expense appears under either SG&A and store preopening. The rent expense could also be included under "prepaid expenses and other current assets" depending on how Build-A-Bear pays installments of the lease.

Part F

i. Pictured below is a table showing the present value of the lease for each period, resulting in a total at the end of the lease's useful life (8 years). Each payment is multiplied by its respective present value factor to get the true value of the dollar amount, which is reflected in the "PV of Payment" column.

Period	Payment	PV factor	PV of Payment
1	$50,651	0.9346	$47,337
2	47,107	0.8734	41,145
3	42,345	0.8163	34,566
4	35,469	0.7629	27,059
5	31,319	0.7130	22,330
6	25,229	0.6663	16,811
7	25,229	0.6227	15,711
8	25,229	0.5820	14,683
		Total PV of Payment	**$219,643**

ii. To record leases as capital leases entered into as a whole on Jan. 2, 2010:

Property, Plant, Equipment	219,643	
Lease Obligation		219,643

iv. To record leases as capital leases in fiscal 2010 including interest and amortization:

Lease Obligation	35, 276	
Interest Expense	15,375	
Cash		50,651

Depreciation Expense	27,455	
Accumulated Depreciation		27,455

Part G

Build-A-Bear's management has incentives to structure their leases as operating leases because they would not increase the liabilities since the lease is not being capitalized. Operating leases also can provide a more positive outlook for the company's financial reporting. Also, operating leases can give a company lower changes in the earlier years of a lease than capital leases. Tax benefits also come with operating leases because installments are paid as expenses. In some circumstances equipment can be tax deductible, lowering the expenses for the company. Finally, equipment can become obsolete quickly, so an operating lease is a good way to not have a long-term commitment to a piece of equipment if it becomes unusable.

Part H

Pictured below is a table presenting the changes in financial ratios if Build-A-Bear were to capitalize their leases. As a result, the current ratio would improve, while the debt to equity and debt to assets ratios would get worse.

	As Displayed in Financials	Capitalized
Current Ratio	1.66	1.83
Debt to Equity	0.73	1.84
Debt to Assets	0.42	0.71