CASE STUDIES OF FINANCIAL ACCOUNTING THEORIES AND TECHNIQUES

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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.

Oxford

May 2018

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ABSTRACT

Walter Douglas Kearney III: Case Studies of Financial Accounting Theories and Techniques

(Under the Guidance of Dr. Victoria Dickinson)

In conjunction with the Patterson School of Accountancy, the Sally McDonnell Barksdale Honors College has developed a program for accounting students that allows for real-world application of the theories and techniques taught as part of the accounting curriculum. This alternative thesis opportunity gives students a chance to complete a variety of case studies that supplement material learned in accounting classes by applying what has been learned in a deeper, more meaningful manner. Each case covers a unique topic within accounting by using a different forms of research and application. Over the course of the year-long class, students dive into the financial statements of companies in conjunction with the use of the FASB Codification and other resources. This is an opportunity to apply what has been learned in class to real-world situations, which provides rich learning experiences. Each case is reported with a combination of explanatory writing and data to back up the findings. Meetings with upper-level employees from major accounting firms also adds to the experience that this class provides. The exposure to professionals from the firms gives students the opportunity to gain a glimpse into the profession, while also establishing a solid base of connections. This unique thesis option enriches foundational components of an accounting education and prepares students for a successful career.

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INTRODUCTION

Findings:

This honors accounting course is based on the application of accounting theories through a series of real-world case studies. Students are supposed to take what is learned in intermediate accounting and apply to actual accounting problems that companies face on a daily basis. Students used a variety of resources, including Microsoft Excel and the FASB Codification, to complement their research for each case. The exposure to these resources allowed students to realize how to bring accounting topics together into a practical application. The critical analysis needed to complete each case study forced students to make the transition from classroom learning to real world use.

Although the studies and work can be detailed and challenging, it makes students appreciate the value of a team. Each case was tackled by a team of students, which enabled students to reach new levels of analysis and understanding. Also, a major component of the accounting alternative thesis track is interaction with both major and regional accounting firms. A broad range of firms presented and visited the class to share with students about the profession. They further strengthened important accounting topics and also emphasized key skills to be successful within the profession. All of the professionals agreed that being able to work on a team is of utmost importance. By having a cohesive team for each case, students were able to replicate work in the accounting world. Although working within a team setting was important, individual understand and analysis was at the foundation of each case. Each team member compiled findings and analyzed them independently. This gave students the chance to apply what they learned based on their understanding of each topic.

Career Development:

One thing that professionals are constantly looking for is quality experience that will allow candidates to make an immediate impact. It is often hard for students to gain this type of experience, but this case study course allows students to make real-world applications for accounting principles and theories learned in class. The accounting profession is one with endless opportunity, as accounting is at the foundation of all business. Although the profession is rapidly evolving, the principles will always remain the same. This course examined these basic principles and applied them in a way that makes the students extremely marketable to accounting firms looking to hire recent college graduates.

As mentioned previously, a major component of the Honors 420 class is the interaction with major accounting firms. Professionals come and share about their respective companies and what a career in accounting looks like. By networking with accountants, students are able to place themselves at the top of the candidate pool. They learn what to expect in interviews, internships and careers. By conducting high level research, exploring the FASB codification, utilizing the power of Excel, and analyzing in a real-world context sets students apart from other candidates. Also, the teamwork component of the class may end up being the most valuable thing learned. All companies rely on teams to tackle major projects, and this class prepares students to be valuable contributors on business world teams. Overall, the class allows students to apply what they learned in a practical manner that makes them significantly more marketable and qualified for open positions within the accounting profession.

CASE STUDY ONE

Home Heaters: Glenwood Heating, Inc. vs. Eads Heaters, Inc.

Financial Analysis and Reporting

Introduction:

The following financial statements and analysis should allow investors to make an informed decision when choosing between Glenwood Heating, Inc. located in Glenwood Springs, Colorado and Eads Heaters, Inc. located in Eads, Colorado. Both of the companies have similar operations that sell small home heating units. The companies operate in very similar manners except for a few differences in accounting procedures chosen by the respective managers, which are accounted for in Part B. The financial analysis and ratios point to Glenwood Heating, Inc. being a better investment, given the current state of both companies.

Part A:

Table 1-1 Basic Transactions

	Assets						= Liabilities			+ Equity	
	Cash	Accounts Receivable	Inventory	Land	Building	Equipment	Accounts Payable	Note Payable	Interest Payable	Common Stock	Retained Earnings
No. 1	160,000									160,000	
No. 2	400,000							400,000			
No. 3	-420,000			70,000	350,000						
No. 4	-80,000					80,000					
No. 5			239,800				239,800				
No. 6		398,500									398,500
No. 7	299,100	-299,100									
No. 8	-213,360						-213,360				
No. 9	-41,000							-20,000			-21,000
No. 10	-34,200										-34,200
No. 11	-23,200										-23,200
No. 12									6,650		-6,650
Balances	47,340	99,400	239,800	70,000	350,000	80,000	26,440	380,000	6,650	160,000	313,450

Table 1-2 Basic Trial Balance

	Debits	Credits
Cash	47,340	
Accounts Receivable	99,400	
Inventory	239,800	
Land	70,000	
Building	350,000	
Equipment	80,000	
Accounts Payable		26,440
Note Payable		380,000
Interest Payable		6,650
Common Stock		160,000
Dividends	23,200	
Sales		398,500
Other Operating Expenses	34,200	
Interest Expense	27,650	
Totals	971,590	971,590

Part B:

Table 1-3 Glenwood Additional Information

	Assets									Liabilities			Stockholder's Equity	
Transaction	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	Retained Earnings
Balances from Part A	47,340	99,400		239,800	70,000	350,000		80,000		26,440	6,650	380,000	160,000	313,450
Part B (1) Bad Debts			-994											-994
Part B (2) Cost of Goods Sold				-177,000										-177,000
Part B (3) Depreciation														
Building							-10,000							-10,000
Equipment														-9,000
Part B (4) Equipment														
Rental Payment	-16,000													-16,000
Part B (5) Income Tax	-30,914													-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	69,542

Table 1-4 Glenwood Trial Balance

	Debits	Credits
Cash	426	
Accounts Receivable	99,400	
Allowance for Bad Debts		994
Inventory	62,800	
Land	70,000	
Building	350,000	
Accumulated Depreciation, Building		10,000
Equipment	80,000	
Accumulated Depreciation, 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, Building	10,000	
Depreciation Expense, Equipment	9,000	
Rent Expense	16,000	
Interest Expense	27,650	
Provision for Income Tax	30,914	
Totals	991,584	991,584

Table 1-5 Eads Additional Information

Transaction	Assets										Liabilities		Stockholder's Equity	
	Cash	Accounts Receivable	Allowance for Bad Debts	Inventory	Land	Building	Accumulated Depreciation, Building	Equipment	Accumulated Depreciation, Equipment	Leased Equipment	Accumulated Depreciation, Leased Equipment	Accounts Payable	Interest Payable	Note Payable	Lease Payable	Common Stock	Retained Earnings
Balances from Part A	47,340	99,400		239,800	70,000	350,000		80,000				26,440	6,650	380,000		160,000	313,450
Part B (1) Bad Debts			-4,970														-4,970
Part B (2) Cost of Goods Sold				-188,800													-188,800
Part B (3) Depreciation																	
Building							-10,000										-10,000
Equipment									-20,000								-20,000
Part B (4) Equipment																	
Lease										92,000					92,000		
Lease Payment	-16,000																-7,360
Lease Depreciation											-11,500						-11,500
Part B (5) Income Tax	-23,505																-23,505
Balances	7,835	99,400	-4,970	51,000	70,000	350,000	-10,000	80,000	-20,000	92,000	-11,500	26,440	6,650	380,000	83,360	160,000	47,315

Table 1-6 Eads Trial Balance

	Debits	Credits
Cash	7,835	
Accounts Receivable	99,400	
Allowance for Bad Debts		4,970
Inventory	51,000	
Land	70,000	
Building	350,000	
Accumulated Depreciation, Building		10,000
Equipment	80,000	
Accumulated Depreciation, Equipment		20,000
Leased Equipment	92,000	
Accumulated Depreciation, 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, Building	10,000	
Depreciation Expense, Equipment	20,000	
Depreciation Expense, Leased Equipment	11,500	
Interest Expense	35,010	
Provision for Income Tax	23,505	
Totals	1,101,420	1,101,420

Table 1-7 Glenwood Income Statement

Glenwood Heating, Inc.
Income Statement
For Year Ended December 31, 20X1

Sales		398,500
Cost of Goods Sold		177,000
Gross Profit		221,500
Operating Expenses		
Selling and Administrative Expenses		
Bad Debt Expense	994	
Depreciation Expense - Building	10,000	
Depreciation Expense - Equipment	9,000	
Rent Expense	16,000	
Other Operating Expenses	34,200	70,194
Income from Operations		151,306
Other Expenses		
Interest Expense		27,650
Income Before Taxes		123,656
Provision for Income Taxes		30,914
Net Income		92,742
Earnings Per Common Share		28.98

Table 1-8 Eads Income Statement

Eads Heaters, Inc.
Income Statement
For Year Ended December 31, 20X1

Sales		398,500
Cost of Goods Sold		188,800
Gross Profit		209,700
Operating Expenses		
Selling and Administrative Expenses		
Bad Debt Expense	4,970	
Depreciation Expense - Building	10,000	
Depreciation Expense - Equipment	20,000	
Depreciation Expense - Leased Equipment	11,500	
Other Operating Expenses	34,200	80,670
Income from Operations		129,030
Other Expenses		
Interest Expense		35,010
Income Before Taxes		94,020
Provision for Income Taxes		23,505
Net Income		70,515
Earnings Per Common Share		22.04

Table 1-9 Glenwood Retained Earnings

Glenwood Heating, Inc.
Statement of Retained Earnings
For Year Ended December 31, 20X1

Beginning Retained Earnings January 1, 20X1	0
Plus: Net Income	92,742
	92,742
Less: Dividends	-23,200
Ending Retained Earnings December 31, 20X1	69,542

Table 1-10 Eads Retained Earnings

Eads Heaters, Inc.
Statement of Retained Earnings
For Year Ended December 31, 20X1

Beginning Retained Earnings January 1, 20X1	0
Plus: Net Income	70,515
	70,515
Less: Dividends	-23,200
Ending Retained Earnings December 31, 20X1	47,315

Table 1-11 Glenwood Balance Sheet

Glenwood Heating, Inc.
Balance Sheet
For Year Ended December 31, 20X1

Assets			
Current Assets			
Cash			426
Accounts Receivable		99,400	
Less: Allowance for Bad Debt Expense		994	98,406
Inventory			62,800
Total Current Assets			161,632
Property, Plant, and Equipment			
Land		70,000	
Building		350,000	
Equipment		80,000	
Less: Accumulated Depreciation, Building	10,000		
Less: Accumulated Depreciation, Equipment	9,000		
Total Accumulated Depreciation	19,000		
Total Plant, Property, and Equipment			481,000
Total Assets			642,632
Liabilities and Stockholders' Equity			
Current Liabilities			
Accounts Payable			26,440
Interest Payable			6,650
Total Current Liabilities			33,090
Long-Term Liabilities			
Notes Payable			380,000
Total Liabilities			413,090
Stockholders' Equity			
Common Stock		160,000	
Retained Earnings		69,542	
Total Stockholders' Equity			229,542
Total Liabilities and Stockholders' Equity			642,632

Table 1-12 Eads Balance Sheet

Eads Heaters, Inc.
Balance Sheet
For Year Ended December 31, 20X1

Assets			
Current Assets			
Cash			7,835
Accounts Receivable		99,400	
Less: Allowance for Bad Debt Expense		4,970	94,430
Inventory			51,000
Total Current Assets			153,265
Property, Plant, and Equipment			
Land		70,000	
Building		350,000	
Equipment		80,000	
Leased Equipment		92,000	
Less: Accumulated Depreciation, Building	10,000		
Less: Accumulated Depreciation, Equipment	20,000		
Less: Accumulated Depreciation, Leased Equipmen	11,500		
Total Accumulated Depreciation	41,500		
Total Plant, Property, and Equipment			550,500
Total Assets			703,765
Liabilities and Stockholders' 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 Liabilities			496,450
Stockholders' Equity			
Common Stock		160,000	
Retained Earnings		47,315	
Total Stockholders' Equity			207,315
Total Liabilities and Stockholders' Equity			703,765

Table 1-13 Glenwood Cash Flows

Glenwood Heating, Inc.
Statement of Cash Flows
For Year Ended December 31, 20X1

Cash Flows from Operating Activities		
Net Income		92,472
Adjustments		
Depreciation Expense, Building	10,000	
Depreciation Expense, Equipment	9,000	
Changes in Current Assets and Liabilities		
Increase in Accounts Receivable	-99,400	
Increase in Allowance for Doubtful Accounts	994	
Increase in Inventory	-62,800	
Increase in Accounts Payable	26,440	
Increase in Interest Payable	6,650	-109,116
Total Cash Flows from Operating Activities		-16,374
Cash Flows from Investing Activities		
Cash Paid for Land	-70,000	
Cash Paid for Building	-350,000	
Cash Paid for Equipment	-80,000	
Total Cash Flows from Investing Activities		-500,000
Cash Flows from Financing Activities		
Cash Received from Issuance of Common Stock	160,000	
Cash Received from Note Payable	380,000	
Cash Paid for Dividends	-23,200	
Total Cash Flows from Financing Activities		516,800
Total Current Year Cash Flows		426

Table 1-14 Eads Cash Flows

Eads Heaters, Inc.
Statement of Cash Flows
For Year Ended December 31, 20X1

Cash Flows from Operating Activities		
Net Income		70,515
Adjustments		
Depreciation Expense, Building	10,000	
Depreciation Expense, Equipment	20,000	
Depreciation Expense, Leased Equipment	11,500	
Changes in Current Assets and Liabilities		
Increase in Accounts Receivable	-99,400	
Increase in Allowance for Doubtful Accounts	4,970	
Increase in Inventory	-51,000	
Increase in Accounts Payable	26,440	
Increase in Interest Payable	6,650	-70,840
Total Cash Flows from Operating Activities		-325
Cash Flows from Investing Activities		
Cash Paid for Land	-70,000	
Cash Paid for Building	-350,000	
Cash Paid for Equipment	-80,000	
Total Cash Flows from Investing Activities		-500,000
Cash Flows from Financing Activities		
Cash Received from Issuance of Common Stock	160,000	
Received Cash for Note Payable	380,000	
Payment of Lease	-8,640	
Cash Paid for Dividends	-23,200	
Total Cash Flows from Financing Activities		508,160
Total Current Year Cash Flows		7,835

Table 1-15 Glenwood vs. Eads

	Glenwood	Eads
Current Ratio	4.88	4.63
Acid-Test Ratio	3.02	3.24
Gross Profit Margin	0.56	0.53
Return on Assets	0.14	0.10
Return on Equity	0.40	0.34
Earnings Per Share	28.98	22.04
Debt Ratio	0.64	0.71

Final Analysis:

There are many things that go into determining the strength of a company, and they should be considered when deciding where to invest valuable capital. One good way to make a decision between Glenwood Heating, Inc. and Eads Heaters, Inc. is to analyze the financial statements and the ratios that can be computed from the disclosed data. When looking at the above ratios, Glenwood Heating, Inc. appears to be the sounder investment. The company seems to be fairly efficient in terms of revenue based on expenditures. Although Glenwood is only slightly better in all of the ratios, this points to the greater idea of them being more efficient and profitable. Businesses that are efficient and profitable are the ones that have long-term viability and earnings potential. Also, some smaller decisions by Glenwood point to them being a well-run company. This includes their lower amount of assets with a corresponding lower level of liabilities. Maximizing assets and minimizing liabilities is another way to determine the future for a company. Other good reasons to consider investing in Glenwood Heating, Inc. over Eads Heaters, Inc. include the higher net income and retained earnings figures. Even though Eads Heaters, Inc. appears to be a stable company, according to recent financial analysis, Glenwood Heating, Inc. is the better investment.

CASE STUDY TWO

Totz Co.

Sales and Related Transactions

Introduction:

The Totz Co. case focused on how to account for certain events and transactions that a company may experience. By using the Financial Accounting Standards Board Codification, a group of generally accepted accounting principles, transactions were able to be entered into the journal correctly. This case looked at specific situations such as unusual events, cost of sales, net sales, and other financials activities of Totz and Doodlez, a subsidiary of the Totz brand.

1. Totz had net sales of $86.5 million in fiscal year 2016, which represents an increase from the total of $74.5 million in 2015. A large portion of this increase was from the strong growth of Doodlez, an in-store art studio that provides art classes. Doodlez sales increased from $3.9 million to $11.2 million in 2016. The rest of the growth is attributed to a higher average transaction total, which is the result of consumer support for the use of new natural fibers in their products. As Totz is preparing its income statement, it must separate the sales from Totz, a retail company and Doodlez, a service oriented arm of Totz. Per Regulation S-X Rule 5-03, which is also under ASC 225-10-S99-2 of the FASB Accounting Standards Codification, "net sales and revenues that should be stated separately include net sales of tangible products, operating revenues of public utilities or others, income from rentals, revenues from services, and other revenues." Totz's revenues and the revenue from Doodlez should be stated separately when preparing the income statement under the sales section.

2. When preparing the income statement for Totz, the gross profit should be reported under the cost of sales. Cost of sales resulting from Totz and Doodlez should be stated separately. Per ASC 225-10-S99-2, "costs and expenses applicable to sales and revenues that should be stated separately are cost of tangible goods sold, operating expenses of public utilities or others, expenses applicable to rental income, cost of services, and expenses applicable to other revenues." Since Totz is a retail company and sells tangible goods, their cost of sales should be stated independent of Doodlez's cost of sales. Doodlez is a service-oriented portion of the company, so the two cost of sales should be separated. Totz's cost of sales are associated with acquiring and producing inventory, while Doodlez cost of sales is the cost of direct labor.

3. The gain of $1.7 million on the sale of the abandoned company headquarters from Totz's relocation should be considered "usual" and the "result of continuing operations" per ASU-225-20-45-4. Gain from the sale of the abandoned corporate headquarters should be put under non-operating income. This event used to be considered an extraordinary item for income statement purposes, as it was a "gain from sale or abandonment of property, plant, or equipment used in the business" (ASC-225-20-45-4), but extraordinary items are no longer accounted for as they were in the past. Therefore, Totz should report this gain under the non-operating income section of the income statement.

4. Totz settled a lawsuit regarding the natural fibers that they were using in production. The gain of $2.7 million from the class action lawsuit should be placed under

non-operating income on the income statement. ASU 225-20-45-16 states that this type of event falls under the descriptors of “unusual” and “occurs infrequently,” meaning it is non-operating and should be listed separately.

CASE STUDY THREE

Basic Accounting Transactions

Introduction:

This case deals with a set of basic transactions and how they flow through all of the financial statements such as the balance sheet, trial balance, income statement, and statement of cash flows. Each transaction is recorded as an entry via an Excel Spreadsheet. Then each transaction is marked based on how it affects different parts of the financial statements. All statements are updated for the given list of business activities that have occurred.

Table 3-1 Entries and Unadjusted Trial Balance

Blue = Operating
Orange = Financing
Green = Investing

		Beginning balance (February 28, 2009)	1. Purchase Inventory	2. Incur Factory wages	3. Sell inventory for cash and on account	4. Pay for inventory	5. Collect receivables	6. 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
	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
Dr.	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
	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											-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	0			22,000,000								944,017	22,944,017
	Franchise and royalty fees	0											5,492,531	5,492,531
	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
Dr.	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	0

Table 3-2 Entries and Post-Closing Trial Balance

Blue = Operating
Orange = Financing
Green = Investing

		Unadjusted Trial Balance	12. Adjust for inventory count	13. Record Depreciation	14. Wage accrual	15. Consultant's report (no entry)	Pre-closing trial balance	16. Closing entry	Post-closing (ending) balance	Actual February 28, 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	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
	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
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	0	22,944,017
	Franchise and royalty fees	5,492,531					5,492,531	-5,492,531	0	5,492,531
	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
Dr.	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	-3,580,077

Table 3-3 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, exclusive of depreciation and amortization expense of $336,009		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 per Common Share	$	0.58
Weighted Average Common Shares Outstanding		6,012,717
Dilutive Effect of Employee Stock Options		197,521
Weighted Average Common Shares Outstanding, Assuming Dilution		6,210,238

Table 3-4 Balance Sheet

Rocky Mountain Chocolate Factory, Inc.
Balance Sheet
For Year-Ended February 28, 2010

Assets	
Current Assets	
Cash and cash equivalents	3,743,092
Accounts receivable, less allowance for doubtful accounts of $395,291	4,427,526
Notes receivable, current	91,059
Inventories, less reserve for slow moving inventory of $263,872	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	
Preferred stock, $.10 par value; 250,000 authorized; 0 shares issued and outstanding	
Series A Junior Participating Preferred Stock, authorized 50,000 shan	-
Undesignated series, authorized 200,000 shares	-
Common stock, $.03 par value; 100,000,000 share authorized; 6.026.938 shares issued and outstanding	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

CASE STUDY FOUR

Kayla's Craft Shop

Internal Controls

Introduction:

Kayla Stevens owns a small craft shop in Oxford, MS and faces the issue of potential fraud occurring in her business. Below are some of the potential sources of fraud for her business and some internal control recommendations that could be implemented to improve the security of her business finances.

Table 4-1 Analyzing Fraud and Internal Controls

Potential Fraud Scheme	Internal Control
Lucy is responsible for recording sales and preparing bank deposits. Given her autonomy with this process, Lucy could be underreporting sales and failing to deposit all of the money.	In order to comply with separation of duties, one employee should be responsible for recording sales and another should be responsible for depositing money for those sales. This separation of responsibility makes it harder for one person to commit this type of fraud.
The store that Kayla owns may have a petty cash fund that was established for smaller and miscellaneous expenses. If they do have a petty cash fund, employees may be incorrectly being reimbursed from the fund.	In order to prevent this and ensure that petty cash fund disbursements are accurate, there should be access controls. Kayla should be the custodian. This means that she is the only person that can make payments. Also, Kayla, serving as the custodian, will need to collect receipts as a way of proving accurate disbursement.
Kayla's store just implemented a new coupon discount program. Employees could be scanning coupons but charging the customers full price and then pocketing the difference.	With this new program, there is limited evidence of processing the transaction. Clerks should have to enter all amounts into the system and keep the coupon with the receipt of the transaction.
There is no evidence of a system to track the hours that each employee works.	Kayla should implement a time card system to track exactly when each employee works.

Potential Fraud Scheme	Internal Control
Kayla is responsible for the oversight of inventory, orders for new inventory, and payments of inventory. She could commit an act of fraud by falsifying orders, paying them to an external account, and expensing more inventory than actual to make up for the difference. This would reduce the income tax expense of the business by underreporting income while funneling cash out of the business.	A separate employee should be responsible for inventory orders and payment of inventory orders. This separation of responsibility would prevent one person from autonomously falsifying orders to be paid to external accounts.
Kayla has full custody of assets, and she also does the record keeping.	Kayla should not be handling so much responsibility within the business since she is the owner of the company. Someone else should be helping with or taking over this area.
Kayla and Lucy both have access to the accounting system, with Kayla handling all accounting functions and Lucy recording sales data and preparing bank deposits.	This is an issue because Lucy and Kayla can both access records, which could lead to small changes to the sales records by Lucy without Kayla realizing it. Thought separation of duties is important, it is also important for the information to be valid and consistent.
There is only one credit card machine for both cash registers.	There is no way of knowing which employee is responsible for the credit card sale. There should be a credit card machine for each register so that credit card transactions can be allocated to the correct employee.
There is no mention of a security system.	If a security system was put in place, complete with cameras, then employees would be monitored at all times.
Each employee has full authority to enter each type of transaction, meaning that they could change previous transactions.	Kaya, as the owner, should be the only person with full authority. All other employees should have limited authority that allows them to only record transactions that are directly related to the sales process.

CASE STUDY FIVE

Inventory and Allowance for Obsolete Inventory

Introduction:

This case examines making inventory investment decisions based on inventory analysis. Different inventories such as raw materials inventory, work-in-process inventory, and finished goods inventory are quantified to help in understanding of the capital that is tied to inventory. Also, obsolete inventory, accounts payable, and cost of goods sold are taken into account when deciding appropriate levels of inventory.

1. Raw materials inventory is made up of the tangible materials that go into the making of the end product. This is the costs of the components that go into making the product. Work in process inventory consists of the costs involved with unfinished units, direct labor that has been used in the production of the unit, and an applicable share of factory overhead. Finally, finished goods inventory represents the cost of the completed units that are on hand at the end of the period.

2. Inventory is recorded net of an estimated amount for obsolete and unmarketable inventory. This amount comes from current inventory levels, sales trends, historical experience, estimates of market conditions, and forecasts for future product demand.

3. a) This account will appear within the balance sheet under the current assets section. Gross inventory will be presented, less allowance for obsolete or unmarketable inventory, which will result in the net inventory for the period.

b) Gross inventory for 2011 would be $243,870, which is the sum of $233,070 and $10,800. The gross inventory for 2012 would be $224,254, which is the sum of $211,734 and $12,520.

c) I think that approximately 45% of the reserve for obsolete and unmarketable inventory would be applied to raw materials inventory, 10% to work in process inventory, and 45% to finished goods inventory. I made this estimate because most units would probably not be started if they are believed to obsolete or unmarketable. Also, if new products or new materials that go into the units were to come onto the market, then this would likely affect raw materials and finished goods most heavily. For example, if a new material goes into making the units, then the on hand raw materials inventory could possibly be deemed obsolete or unmarketable. This same idea applies to finished goods inventory, as units could be completed and then a new type of unit could take its place in the market. This would lead to obsolete or unmarketable inventory on hand.

4.

1/31/12	Cost of Sales		13,348	
		Allowance for Obsolete & Unmarketable Inventory		13,348
12/31/12	Allowance for Obsolete & Unmarketable Inventory		11,628	
		Finished Goods Inventory		11,628

5. T-Accounts

Raw Materials Inventory	
$46,976	$442,068
$438,561	
$43,469	

Work-In-Process Inventory	
$1,286	$568,735
$126,000	
$442,068	
$619	

Finished Good Inventory	
$184,808	$13,348
$568,735	$572,549
$167,646	

Cost of Sales	
$-	
$13,348	
$572,549	
$585,897	

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

6. The inventory turnover ratio was found by dividing the cost of sales by the net average inventories. The net average inventories were found by taking the two inventories and finding a simple average.

   Inventory Turnover Ratio 2011 = (575,226) / [(268,591 + 233,070) / 2] = 2.29

   Inventory Turnover Ratio 2012 = (585,897) / [(233,070 + 211,734) / 2] = 2.63

7. The inventory holding period is a measure of how many days it takes the company to manufacture and sell its inventory. It is found by dividing 365 days by the inventory turnover ratio found in part six.

   Inventory Holding Period 2011 = (365) / (2.29) = 159.39

   Inventory Holding Period 2012 = (365) / (2.63) = 138.78

Over the course of a year, the company became significantly more efficient in its inventory management as the holding period decreased from 159.39 to 138.78. This represents a nearly fifteen percent improvement over just one year.

8. Percentage of Finished Goods Estimated to be Obsolete = 13,348 / 184,808 = 7.22%

   As an investor, I would like to know more about the methods behind determining the portion of finished goods deemed obsolete. Also, I would like to know if this amount is in line with previous yearly averages for amounts of finished goods estimated to be obsolete. If the numbers are in line with yearly averages, then this would be normal and not raise any concerns as an investor. If this number was significantly higher than previous years, then it would raise a red flag as an investor. Another thing to consider would be the return policy of the company and how this impacts the number of goods that are deemed obsolete on a yearly basis.

CASE STUDY SIX

WorldCom, Inc.

Capitalized Costs, Earnings Quality, and Depreciation

Introduction:

This case is based on WorldCom Inc. and how they committed accounting fraud by incorrectly classifying costs in their financial statements. This led to a falsified increase in their net income, which triggered one of the largest accounting scandals in American history.

Concepts

a. i. Assets are defined as the likely future benefit for a particular firm from actions in the past according to FASB Statement of Concepts No. 6. Also, assets can be considered as the present value of future cash flows. Expenses are seen as the using up of assets or the bringing on of new liabilities to continue the central operations of a firm according to the FASB Statement of Concepts.

   ii. Costs should be capitalized when they increase the output, increase efficiency, or otherwise improve the earnings-potential of a specific asset. Costs should be expensed when they do not increase the earnings-potential of a specific asset in a material way. This means that costs are expensed rather than capitalized when they do not increase the overall future economic benefit of an asset.

b. After costs are initially capitalized, they become a part of a depreciable asset. This means that the capitalized costs are eventually expensed through annual depreciation expense. Depreciation is a much slower process for expensing something compared to expensing something all at once. The value of assets

increases upon capitalization and then expense is slowly applied throughout the useful life of the asset.

Process

c. WorldCom, Inc. reported line costs for the year ended December 21, 2001 as $14,739,000,000. The line costs that WorldCom, Inc. incurred in large amounts were the costs associated with paying local telephone providers to complete calls for WorldCom, Inc. customers. This process connected calls made by WorldCom, Inc. users with users throughout the country and world.

Journal Entry:

12/31/2001	Line Costs Expense	14,739,000,000	
	Cash		14,379,000,000

d. WorldCom, Inc. was improperly capitalizing line costs along with other things to all of their assets such as transmission equipment, communications equipment, furniture, and fixtures. The line costs that WorldCom, Inc. incurred to connect their users to phone networks were not providing future economic benefit to the assets in which they were being capitalized. This means that these line costs should have been recorded as expenses rather than being capitalized. This drastically reduced yearly expenses, which in turn propped up annual net income. This led to false representation of the financial position of WorldCom, Inc. and the ultimate failure of the company.

e. The line costs appear on the balance sheet as part of the assets under plant, property, and equipment, as the expenses were improperly capitalized into these

assets. They would be found under the investing activities portion of the statement of cash flows as a capital expenditures item.

Journal Entry:

12/31/2001	Plant, Property, and Equipment	3,055,000,000	
	Line Costs Expense		3,055,000,000

Analysis

f. WorldCom, Inc. Depreciation Expenses (in millions) for 2001

Based on Midpoint Useful Life of 22 Years

Quarter 1: ($771/22) x (4/4) = $35,045,454.55

Quarter 2: ($610/22) x (3/4) = $20,795,454.55

Quarter 3: ($743/22) x (2/4) = $16,886,363.64

Quarter 4: ($931/22) x (1/4) = $10,579,545.45

Total Depreciation Expense for 2001 = $83,306,818.19

Journal Entry:

12/31/2001	Depreciation Expense	83,306,818	
	Accumulated Depreciation		83,306,818

g. The difference in net income is material, as the net income for WorldCom, Inc. went from $1,501,000,000 in 2001 to a net loss of $341,150,568.

Table 6-1 Restated Net Income

Income before taxes, as reported	2,393,000,000
Add back depreciation for year	83,306,818
Deduct line costs that were improperly capitalized	-3,055,000,000
Loss before taxes, restated	-578,693,182
Income tax benefit (35%)	202,542,614
Minority interest	35,000,000
Net loss, restated	-341,150,568

CASE STUDY SEVEN

Targa Co.

Accounting for Employee Termination Benefits, Retraining, and Relocation Costs

Introduction:

This case is based on the Targa Co. and how they should account for various expenses when putting together their financial statements. This analysis includes how to represent employee benefits within the statements and how retraining as well as relocation should be accounted for based on the FASB Codification.

1. Per ASC 712-10-25-1 in the FASB Codification, "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." In the case of Targa Co., this correlates with the $500,000 that the company is paying for two weeks' severance. Upon the decision of employees to accept the offer as part of the restructuring plan for Targa Co., this will be recognized as a liability and loss as stated in the FASB Codification. Also, included under this provision is the $50,000 that the facility manager will contractually receive due to his employment agreement. It will also be recorded as a loss and liability, as it can be considered a "special termination benefit." This means that the loss and liability is recognized when the employees accept the offer. The other $2.5 million that makes up the one-time termination benefit for employees should be accounted for in a different manner. According to ASC 420-10-25, "A liability for a cost associated with an exit or disposal activity shall be recognized in the period in which the liability is incurred." This means for the one-time termination benefit for employees that totals $2.5 million, Targa Co. should account for it as a liability associated with exit and/or relocation costs. Per ASC 420-10-25-4, requirements must be met to consider it a

one-time benefit. This meets all of the requirements as management commits to the plan, the plan identifies the number of employees impacted, the plan establishes the terms, and there is no indication that there will be significant changes to the plan. All of this goes into accounting for the one-time termination benefit as a liability.

2. The relocation costs of $500,000 should be accounted for as an additional cost associated with an exit activity. Per ASC 420-10-15-14, “other costs associated with an exit or disposal activity include, but are not limited to, costs to consolidate or close facilities and relocate employees.” The $1.5 million for staff training costs will be considered a liability and will be expensed as incurred. This is outlined in ASC 420-10-25-15 which states, “A liability for other costs associated with an exit or disposal activity shall be recognized in the period in which the liability is incurred.” The training costs are directly related to the relocation plan, so this is considered one of the “other costs associated with an exit or disposal activity.” The expenses will not be recorded until the employees have been both relocated and trained.

CASE STUDY EIGHT

Merck and Co., Inc.

Shareholders' Equity

Introduction:

This case study examines the shareholders' equity of Merck & Co., Inc., a global pharmaceutical company. Within in the study, we considered the treasury stock, common stock, and dividend activities of the firm. These numbers were derived from a variety of financial statements including the balance sheet, statement of cash flows, and statement of retained earnings. Ratios and critical analysis accompany these findings to help in the understanding of this case study.

a) i) Merck is authorized to issue 5.4 billion shares of common stock.

ii) By December 31, 2007, Merck issued 2,983.51 million common shares.

iii) The dollar value of common stock reported on the balance sheet is $29.84 million, which represents a one cent par value for the common stock.

iv) By December 31, 2007, there are 811.01 million shares held in treasury.

v) For Merck, there would be 2.17 billion (2,983,508,675 - 811,005,791) shares that are still outstanding.

vi) The total market capitalization for Merck on that day would be $125,157,891,147.00, which is found by multiplying the number of shares outstanding by the market value per share. Market Capitalization = Shares Outstanding * Price per Share.

c) Companies pay dividends to keep shareholders happy and to give them some return on their investments. Dividends represent a way for shareholders to have some income from their investments other than just capital gains, which are only recognized upon selling the shares. When a company pays dividends to its shareholders, it typically causes share price to decrease because this shows sign of slowed growth in the future. Rather than investing to promote future growth with the money that goes towards dividends, they are signaling that there may not be much growth opportunity in the future.

d) Companies repurchase their own shares because they believe that their shares are undervalued on the market. They also repurchase shares when they have excess cash because of the opportunity for capital gain. If the stock is believed to be undervalued, then they may buy back to resell them at a higher price in the future. Another possibility is to increase the earnings per share by reducing the number of shares outstanding. Also, they may want to bring back ownership interest if they think that a takeover is possible.

e) Retained Earnings $3,310.7 million

Dividends Payable $3.4 million

Cash $3,307.3 million

g) i) Merck accounts for its treasury stock transactions using the cost method, which means they put it on their book at the market value at which they repurchase shares.

ii) Merck repurchased at 26.5 million shares on the open market during 2007.

iii) In 2007, Merck payed $1,429.7 million in total for the repurchases, which comes to $53.95 per share ($1,429,700,000 / 26,500,000 shares). This is represented within the financing portion of the statement of cash flows.

iv) Merck does not disclose its treasury stock as an asset because Merck cannot earn income on its stock.

i) **Table 8-1 Merck's Yearly Dividend Comparison**

Merck & Co., Inc.		
(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	(3,307.3 / 2,172.5) = $1.52	(3,322.6 / 2,167.8) = $1.53
Dividend Yield (dividends per share to stock price)	(1.52 / 57.61) = 2.64%	(1.53 / 41.94) = 3.65%
Dividend Payout (dividends to net income)	(3,307.3 / 3,275.4) = 1.01 or 100.97%	(3,322.6 / 4,433.8) = 0.75 or 74.94%
Dividends to Total Assets	(3,307.3 / 48,350.7) = 0.0684 or 6.84%	(3,322.6 / 44,569.8) = 0.0745 or 7.45%
Dividends to Operating Cash Flows	(3,307.3 / 6,999.2) = 0.4725 or 47.25%	(3,322.6 / 6,765.2) = 0.4911 or 49.11%

Between the end of 2007 and 2008 the number of dividends that are paid out decreases by approximately $15 million. The only ratio that increases over time is dividends to net income, while all other ratios decrease by the end of 2007.

CASE STUDY NINE

Xilinx, Inc.

Stock-Based Compensation

Introduction:

This case study focuses on stock-based compensation for employees of Xilinx, Inc. The study considers how to account for the compensation based on the type of option and who is receiving it. Also, restricted stock units are included, as they are becoming more common.

Concepts

Part A:

Equity incentive plans via stock option plans give employees the opportunity to be compensated with stock from the firm. This allows them to purchase stocks in the company as part of their compensation package. Stock option plans incentivize high job performance because the success of the firm usually correlates with the value of their stock. For Xilinx, Inc. the plan allows vested employees, or those that have worked for the company for a minimum of four years, to purchase shares at 100% of the fair market value at the recorded date of granting. This incentivizes employees to work hard on behalf of the company, so they will have the opportunity to buy shares at a lower price than the current market value in the future.

Part B:

Restricted stock units or RSUs are options that are more secure and less risky than normal stock options. Historical stock options have been known for large payouts, but they can be deemed worthless if the stock price drops over time. There is guaranteed money associated with RSUs, whether the company's value appreciates or not. Essentially, it offers the full value of the stock at a future date.

Upon meeting vesting requirements, the employee has the right to purchase the stock at the given price. While traditional stock options can lead to large payouts, RSUs are the safer option as they have defined value in the future, no matter the performance of the company. It is good to offer both to employees because the employee can decide the level of riskiness they want to associate with this part of their compensation.

Part C:

i) Grant date is the first day in which stock options are offered to employees. This is usually part of compensation for employees, often executives. It also determines the fair market value for the option.

ii) The exercise price is the price that the owner of the stock option is guaranteed as part of their plan.

iii) The vesting period is the amount of time that the employee must serve to have the right to formally exercise the stock options that they have been issued.

iv) The expiration date is the date in which the employee no longer has the right to exercise the issued stock options at the exercise price. Essentially, options must be exercised by this date.

v) When restricted stock units are issued, they are given to employees as a form of stock option compensation. Essentially, this special type of stock option guarantees that upon vesting, employees will receive some defined value, no matter the performance of the company.

vi) Options exercised are the options that have been used to purchase stock before the expiration date.

vii) Options that are cancelled or forfeited are those that have not been exercised prior to the expiration date.

Part D:

Xilinx's stock option plans are defined on page 63 of the annual report. Xilinx, Inc. is different from many companies in that they incentivize their workers by having a 24-month purchase right with only a 6-month exercise time frame. The Employee Stock Purchase Plan administered by Xilinx, Inc. is both generous to employees and effective for the company, as more than three quarters of the employees participate in the program. Each employee can purchase common stock up to 15% of their total earnings for the year. They are offered a stock price that is 85% of the lower of the fair market value at the beginning of the 24-month offering period or at the end of each 6-month exercise period. This program is not considered a traditional stock option nor a RSU due to the different guidelines on exercise price and period. Xilinx, Inc. found that their program is a healthy balance that fairly compensates employees, while also incentivizing them to make the company successful in both the short and long-run.

Part E:

Xilinx, Inc. must account for all stock option activities throughout the year based on several factors. First, the overall cost of stock options, RSUs, and the employee stock purchase plan is based on the fair value of the common stock on the grant date. These options are then expensed as compensation expense over the

vesting period. The vesting period is also known as the period that the employee must work to exercise the option. The compensation expense is expensed over time using the straight-line method. As previous awards continue to vest over time, Xilinx, Inc. expenses the unvested portion. The alternative transition method is used to determine excess tax benefits in relation to tax shortfalls.

Process

Part F:

i) The total stock-based compensation for Xilinx, Inc. in 2013 was $77,862.

ii) Xilinx would report this within the cost of goods sold, research and development expense, and selling, general, and administrative expense portions of the income statement. This is due to multiple categories under which employees fall that receive stock-based compensation.

iii) These costs are then added back in the operating section of the cash flow statement.

iv) The income tax effect for 2013 is $22,137, which is known as a deferred tax asset.

v)

Cost of Goods Sold	6,356	
Research and Development Expense	37,937	
Selling, General, and Administrative Expense	33,569	
Additional Paid-In Capital-Stock Options		77,862
Deferred Tax Asset	22,137	
Income Tax Payable		22,137

Analysis

Part I:

i) In recent years, there has been a movement away from traditional stock options to restricted stock options. From the view of companies, this transition simplifies the tax and accounting processes. This trend is probably due to the volatility of the markets and economy. The RSUs provide less risk and more guaranteed compensation for employees, while also reducing the administrative burdens of historical stock options on corporations.

ii) The information within the financial statements for Xilinx, Inc. confirm the trend discussed in the previous part. This is supported by the decrease in pre-tax intrinsic value of traditional stock options from $38.9 million in 2012 down to $35.6 million in 2013. Also, $48.0 million worth of RSUs were vested in 2013, which is greater than the $38.9 million of traditional stock options. The $146.1 million worth of non-vested RSUs indicates the large shift towards RSUs.

CASE STUDY TEN

Bier Haus

Revenue Recognition

Introduction:

In this case study, four different events regarding revenue recognition for Bier Haus are explained and then the 5-step revenue model is applied. Each type of revenue of recognition has certain guidelines that can be found in the FASB Codification. Upon researching the Codification, revenue is classified and the journal entries for each scenario are dependent upon the definition of revenue.

Part I:

1) Identify the contract(s) with a customer: The contract consists of the agreement that the bartender will exchange the beer with the customer for $5.00.
2) Identify the performance obligations in the contract: The bartender is obligated to serve the customer the beer that he or she ordered.
3) Determine the transaction price: In this situation, the price is $5.00.
4) Allocate the transaction price to the performance obligations in the contract: The transaction price of $5.00 is directly allocated to the performance obligation of serving the beer to the customer.
5) Recognize revenue when (or as) the entity satisfies a performance obligation: The revenue is recognized when the bartender gives the beer to the customer.

Journal Entry:

Cash	5.00	
Sales Revenue		5.00

Part II:

1) Identify the contract(s) with a customer: The contract is identified when the customer and the bartender agree to exchange the beer and the mug for $7.00.
2) Identify the performance obligations in the contract: The bartender is obligated to serve the customer the beer in the mug that was purchased.
3) Determine the transaction price: For this transaction, the price is $7.00
4) Allocate the transaction price to the performance obligations in the contract: The transaction price is proportionately divided into the beer and the mug based on the standalone price of each. This means that 5/8 of the price is allocated to the beer and 3/8 of the price is allocated to the mug. This is based on the price that Bier Haus would charge for each product if they were sold separately.
5) Recognize revenue when (or as) the entity satisfies a performance obligation: The revenue is recognized when the bartender gives the patron the mug full of beer.

Journal Entry:

Cash	7.00	
Sales Revenue-Mug		2.63
Sales Revenue-Beer		4.37

Part III:

1) Identify the contract(s) with a customer: The contract can be identified as the agreement between the employee and the customer to purchase a beer and a coupon that is good for 2 pretzels for a total of $7.00.
2) Identify the performance obligations in the contract: In this situation, the performance obligation consists of serving the beer to the customer and providing a coupon that is redeemable for 2 pretzels for $7.00 at a later date.
3) Determine the transaction price: The transaction price is $7.00.
4) Allocate the transaction price to the performance obligations in the contract: The proper allocation for the transaction price of $7.00 is based on the stand-alone prices of the transaction components. The transaction price is based on performance-obligation at stand-alone prices. A beer by itself costs $5.00 and a coupon costs $3.50. This means that ((3.50/8.50) x 7.00) is allocated for beer revenue and ((5.00/8.50) x 7.00) is allocated to unearned sales revenue for pretzels. The numbers are $4.12 for beer and $2.88 for unearned sales revenue of pretzels, respectively.
5) Recognize revenue when (or as) the entity satisfies a performance obligation: Bier Haus will recognize the $4.12, which is the revenue associated with the beer. The revenue that is generated from the pretzels will recognized at a later date.

Journal Entry:

Cash	7.00	
Sales Revenue-Beer		4.12
Unearned Sales Revenue-Coupon		2.88

Part IV:

1) Identify the contract(s) with a customer: The contract goes back to the contract from the previous situation. The contract can be identified as the agreement to purchase the beer and a coupon towards two pretzels for $7.00.
2) Identify the performance obligations in the contract: The obligation consists of Bier Haus providing the beer and the coupon that can be used towards pretzels at a later date.
3) Determine the transaction price: The transaction price for this scenario is $3.11.
4) Allocate the transaction price to the performance obligations in the contract: The price allocated to this portion of the contract is the portion allocated to the pretzels, which is $3.11.
5) Recognize revenue when (or as) the entity satisfies a performance obligation: Bier Haus will recognize the $3.11, which was a liability until it was earned at the time of coupon redemption.

Journal Entry:

Unearned Sales Revenue-Pretzels	3.11	
Sales Revenue-Pretzels		3.11

CASE STUDY ELEVEN

ZAGG Inc.

Deferred Income Tax

Introduction:

This examines deferred income tax scenarios using the financial reports of ZAGG Inc. Deferred tax assets and liabilities are defined and explained by using applicable financial reports from ZAGG Inc. The difference between financial income and taxable income is explained through the differences in rules for accounting and taxing.

Part A:

Book income, also known as financial income, is the income that is presented within the financial statements of a company. It is the number that is reported prior to tax expenses. Essentially, this means that the number in the financial statements is probably not the same income amount that is used within the tax returns for a corporation. The book income for ZAGG Inc. in 2012 is $23,898,000, which is the income before provision for income taxes. Taxable income on the other hand is the amount that has exemptions and reductions applied using the tax laws and regulations. This ultimately leads to two different income numbers.

Part B:

i. Permanent tax differences are differences that arise when something is reported for book purposes, but it will never be recognized for tax purposes. Permanent differences typically come from the variations in verbiage between GAAP and tax codes and will never be reversed. An example of this is entertainment expenses that most corporations incur while trying to keep customers happy. Companies can expense one

hundred percent of entertainment expenses for book purposes, but they are only able to expense fifty percent for tax purposes.

ii. A temporary tax difference arises due to inconsistencies between accounting principles and tax rules. These differences come from irregularities in recognizing revenue and recording expenses. This all means that some things are recognized as revenue in one year and then deferred in the next year for tax reporting purposes. This can be applied the other way around as well. For example, depreciation can be applied in many ways based on the desired impact for current-year income or expenses. For example, one depreciation method may be used for tax purposes to lower income and then applied another way for book purposes.

iii. The statutory tax rate is the percentage that one is taxed as defined by the law. Ultimately, this is the amount that the government mandates that citizens must pay in taxes. In the United States the statutory tax rate is 35%.

iv. The effective tax rate is the amount that one ends up paying in taxes compared to income. This is the percentage that is found by dividing tax expense by income before tax.

Part C:

Companies report deferred income taxes as part of their total income tax expense due in large part to the fact that those deferred taxes will ultimately turn into tax expense at a later date. The figures on a tax return may not represent all of the taxes actually paid by a company during the year. Therefore companies, such as ZAGG Inc., must consider deferred tax assets and deferred tax liabilities when determining actual tax expense for the year.

Part D:

Deferred tax assets represent an amount of tax expense that has been prepaid or overpaid This is considered an asset on the balance sheet because the excess amount will come back to the company as tax relief in the future. Deferred tax liabilities are not paying taxes and carrying them over as a liability to the next period. One example of a deferred tax asset is carrying a loss to the next tax period to reduce future tax expenses. A time that a deferred tax liability comes into play is with different methods of depreciation or different types of revenue recognition. By using the straight-line compared to the accelerated depreciation method, tax expense will be affected as the cost of something is spread out over time in different amounts.

Part E:

A deferred income tax valuation allowance is the portion of deferred tax assets that will ultimately not be realized as tax relief in the future. This means that all deferred tax assets may not be able to be applied to future tax bills due to tax rules and regulations. An allowance is created when the company can reasonably estimate the amount that will not be used based on their previous experience and their future projections. This allowance must take into account the performance of the company and the different rules that apply to the deferred tax assets that the company holds. This means that some of the deferred tax assets may expire or may not be applicable for future tax relief usage.

Part F:

i) Income Tax Expense 9,393,000

Net Deferred Tax Asset 8,293,000

Income Tax Payable 17,686,000

ii) Income Tax Expense 9,393,000

Deferred Tax Asset 8,002,000

Deferred Tax Liability 291,000

Income Tax Payable 17,686,000

iii) Effective Tax Rate = (Tax Expense) / (Pre-Tax Income)

ETR = (9,393,000) / (23,898,000) = 39.3%

This number for ZAGG Inc. is higher than the federal statutory rate of 35%. The difference between the effective and statutory rate are generally attributed to the permanent tax differences.

iv) The current net deferred tax assets in the amount of $6,912,000 can be traced back to the current assets section of the balance sheet. The noncurrent net deferred tax assets totaling $6,596,000 can be traced back to the noncurrent asset part of the ZAGG Inc.'s balance sheet. This would be important to a financial statement user because some assets apply to the current period, while others are applicable in future periods.

CASE STUDY TWELVE

Build-A-Bear Workshop Inc.

Leases

Introduction:

This case study on Build-A-Bear Workshop, Inc. deals with their lease obligations on how to account for them based on the type of lease. The case examines the different forms of lease agreements. Based on the lease, appropriate entries are then made and ratios are calculated. Finally, this is all analyzed based on operating and capital leases for Build-A-Bear Workshop, Inc.

Concepts

Part A:

There are a variety of reasons that a company would decide to lease an asset rather than purchase it. Obsolescence is something that comes into play with assets many times. By leasing, a company is not committed to the asset for eternity and they can upgrade to new types of equipment upon the end of the lease. Lease agreements also provide flexibility because they may not be as strict compared to bond agreements. One advantage of leasing that is attractive to companies is the tax benefit. Leased assets can be capitalized and depreciated even though they are not owned by the entity, which provides obvious tax benefits. The financing of leased assets can be an off-balance sheet activity, meaning that they will not impact financial ratios and can help in increasing borrowing capacity of a firm. The advantages of leasing assets are something that all companies must consider depending on their business strategy and industry.

Part B:

Operating Lease: An operating lease is a shorter-term lease that allows the lessee to not record the asset on their balance sheet. They usually do not have the option to purchase the asset at the end of the lease, so it is returned to the lessor upon the end of the agreement. This means that the lessee is responsible for the condition of the equipment. These types of leases are utilized when a firm must constantly replace a certain type of equipment, such as leasing a new photocopier every three years.

Capital Lease: A capital lease is where the lessor serves solely as a financer for the deal, as the lessee takes on temporary ownership of the leased asset. The asset is then added as an asset on the lessee's balance sheet. This means that all rights of the asset are transferred to the lessee as a result of the transaction. A capital lease is often considered a purchase of an asset, while an operating lease is handled as a true lease in terms of accounting principle. Also, an obligation or liability is recorded, such as a note payable.

Direct-Financing Lease: Essentially, the cost of the asset is equal to the fair value of the asset. This is applicable to firms that purchase equipment for the sole purpose of earning revenue from leasing it to lessees. Interest revenue is the only type of income that is generated by this type of lease.

Sales-Type Lease: This is where the cost the asset does not equal to the fair of the value asset. The lessor can earn profit through interest revenue on the asset as well as an additional profit. The fair value at the beginning of the lease varies from the book value of the lease. This is often used in real estate situations as the carrying value can fluctuate.

Part C:

Accountants distinguish between the different types of leases because different terms are within each type of lease. In some cases, the lessee considers the asset on their balance sheet, while in other cases it is not used in the financial statements of the firm. Also, some types of leases include capitalization and deprecation, so accountants must have different categories of leases.

Process

Part D:

i. This lease will be treated as an operating lease because of the lack of a bargaining option and the fact that at the end of the lease the title does not transfer to the lessee. Also, the lease term of five years is less than the useful life of the location, which is twenty-five years. This means that the lease does not meet the criteria for a capital lease, making it an operating lease.

ii.

Lease Expense	100,000	
Cash		100,000

iii. Year 1 of Lease:

Lease Expense	100,000	
Deferred Lease Expense		100,000

Years 2-5 of Lease:

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

Part E:

i. Build-A-Bear Workshop, Inc. spent $46.8 million on rent expense for operating leases in fiscal year 2009.

ii. This expense appears under the general, administrative, and selling expenses section on the company's income statement.

Analysis

Part F:

i. **Table 12-1 Present Value of Future Minimum Lease Payments**

	Interest Rate = 7%		
Year	Lease Payment	Present Value Factor	Present Value 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	16,810.93
7	25,229	0.6227	15,711.15
8	25,229	0.5820	14,683.31
			219,643.12

ii.	Property and Equipment	219,643.12	
	Lease Obligation		219,643.12
v.	Lease Obligation	35,275.98	
	Interest Expense (219,643.12 x .07)	15,375.02	
	Cash		50,651.00
	Depreciation Expense	27,455.39	
	Acc. Depr. - Property & Equip.		27,455.39

Part G:

Build-A-Bear Workshop, Inc. management has tax incentive to structure leases as operating leases. The lease expense can be classified as operating expense, which lowers net income. Lower net income results in a lower tax burden, and ultimately lower tax expense for the firm.

Part H:

In the case that Build-A-Bear Workshop, Inc. capitalizes its lease obligations, the current, debt-to-equity, long-term debt-to-total assets ratios would all be impacted. The current ratio would decrease because lease liabilities would go below cash outflows within the period. The debt-to-equity ratio would certainly increase, as lease liabilities when increase when the lease is capitalized. Finally, the long-term debt-to-total assets ratio would remain relatively flat before increasing down the road.