Omega Tech Case: Putting it all together

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Abstract

Intermediate accounting students often have difficulty "connecting the dots" with the large amount of technical information covered in class, which is traditionally taught as separate topics. This case attempts to assist students to recognize the interconnectedness of capital leases, defined benefit pension plans, deferred taxes, fixed asset transactions, and cash flows through the correction of errors, and preparation of financial statements. Students are also required to prepare disclosures relating to the transactions.

Introduction

You have been hired as the controller for Omega Tech, Inc., and are preparing for your first year-end. The fiscal year is ending this week, and you are involved in the year-end closing and preparation of the financial statements. You are excited about your new job, and you want to impress your supervisors.

Omega Tech has previously relied on its accounting firm, Frank and Candid, to prepare their financial statements. The company has experienced rapid growth and has decided to hire a controller. The accounting department consists of you and a bookkeeper, Ana Stays. Ana is very capable at handling the day-to-day activities, but doesn't understand some of the finer points of GAAP.

The following sections summarize background information on the Company, major transactions during the past year, and current economic conditions.

Company Background

A group of MBA students formed Omega Tech (the Company) after graduation in 1998. The Company designs and installs home technology applications. Although the Company has not been profitable in the past, this year it has reached a turning point as the profits from past R & D expenditures are being realized in product innovations and in increased sales. To further ensure its success, the Company has embarked on a focused effort to control costs. As the result of these efforts, the Company expects to recognize its first profit in 2012. However, the Company's ultimate success depends on whether it will continue to be profitable over the next few years.

The Company's strength is its management, research and development, and production employees. The average employee is 35 years old, educated, and dedicated. Starting salaries are above average (although salary increases are close to average), morale is strong, and the Company has experienced little turnover. In addition to good salaries and healthcare benefits, all employees are covered by a defined benefit pension plan. The pension plan provides retirement benefits based on the employees' pre-retirement salary levels and years of service with the firm. The Company amortizes any unrecognized prior service costs and gains/losses using the straight-line method over the average remaining service life.

The future outlook for the Company has improved, but it is still uncertain. Analysts are bullish on the Company and have rated its common stock as a buy. The current market price of the Company's common stock is $4.25 per share, and the 2011 average price was $3.65 per share. At the beginning of the current year, the Company had accumulated net operating loss carry-forwards totaling $230 thousand that will begin to expire in ten years. Based on the Company's analysis, management determine that it was "more likely than not" all of the deferred tax asset would be realized in 2012; therefore, the deferred tax asset related to the NOL was classified on December 31, 2011 as current. Deferred tax information for January 1, 2012 is given in Exhibit 3.

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Case ID 030201

Major transactions during the past year

During the past year, the Company was a party to a number of major transactions that impacted the financial statements. These transactions are discussed in the following paragraphs.

Pension Plan

The Company contributes to a defined benefit plan for its salaried employees. Benefits are determined based on years of service and earnings. The Company adopted SFAS no. 158 in 2007, and at the beginning of 2012 amended the plan by increasing the benefits formula, although they did not fund the increased liability of $280,000 at that time. When The Company funded the pension for the year, on December 31, Ana prepared the following entry:

Pension expense	200,000
Cash	200,000

Pension information is given in Exhibit 2

Leases

The Company entered into two lease agreements during the year:

1. A ten-year lease (Jan 2, 2012-Jan 1, 2022) for the use of a high-speed assembly line at its main production facility with General Capital. The lease requires annual payments of $30,000 beginning on January 2, 2012. The lease does not contain a bargain purchase option or transfer title at the end of the lease term, but does include a guaranteed residual value of $20 thousand. The Company estimated the useful life of the assembly line to be twelve years. The Company is unaware of General Capital's implicit interest rate and used a 10 percent interest rate in its lease analysis. Amortization of the capitalized lease asset for financial statement and tax purposes is the same.
   Ana has made the following entry to record the lease payment:

Lease expense	30,000
Cash	30,000

2. A five-year lease (April 1, 2012-March 31, 2017) for the use of a building. The lease requires annual payments of $45,000 starting on April 1, 2012. The lease does not contain a bargain purchase option or transfer title at the end of the lease term, but includes an unguaranteed residual value of $60,000 at the end of the lease. The interest rate implicit in the lease is 12%, which approximates The Company's incremental borrowing rate. The fair value of the building on April 1, 2012 was $213,200. The expected economic life of the building is 30 years. Ana recorded the lease payment as follows:

Lease expense	45,000
Cash	45,000

Construction Project

The Company commenced construction of a new office building on January 1, 2011. The project is expected to be completed in three years. During 2012 the Company incurred construction

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expenditures of $360,000 on March 1; $600,000 on June 1; $1,500,000 on July 1; and $1,260,000 on December 1. To help finance the construction, the Company borrowed $1,200,000 at 12% on January 1, 2011, using the constructed asset as collateral for the loan. In addition, The Company had the following borrowings:

Long-term note:	$600,000 at 10% (borrowed on 12/31/10)
Bonds payable	$3,000,000 at 11% (issued at a discount of $169,517 on 12/31/2008 to effect 12% interest)
Mortgage payable	$3,200,000 at 6% (borrowed on Jan 1, 2012)

Operational Assets

The Company, upon reviewing expenses for gasoline, decided their service calls to customers could be handled with a van, rather the truck they had been using. They located a van and exchanged their truck for the van, and received $6,000 cash in the exchange. At the time of the exchange, after updating depreciation expense, the truck was on the balance sheet at its original cost of $55,000, with $12,000 of accumulated depreciation. Kelley Blue Book estimate for the value of the truck on the date of the exchange was $48,000. Ana recorded the exchange, which occurred on Oct 31, as follows:

Van	37,000
Cash	6,000
Accum depr-truck	12,000
Truck	55,000

Also, on May 1, The Company purchased land, a building and equipment from a bankrupt firm, paying $330,000. In order to determine the values of the assets, the company hired an appraiser, and paid her $6,000. The appraised values were as follows:

Building	$175,000
Land	75,000
Equipment	150,000

The purchase was recorded as follows:

Miscellaneous expense	6,000	
Building	175,000	
Land	75,000	
Equipment	150,000	
Cash		336,000
Gain		70,000

Ana has not recorded depreciation expense on the assets acquired through either transaction.

Other transactions:

At the beginning of 2012, The Company had 539,000 shares of common stock outstanding. An additional 38,500 shares were issued on January 1, 2012.

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Required

1. Review the preliminary financial statements and supporting data for Omega Tech. Prepare the journal entries and update the preliminary statements (round all percentages two decimal places).

2. Submit the completed financial statements, including comparative Balance Sheets for 2011 and 2012; an Income Statement for 2012; and a Statement of Cash Flows for 2012. Include journal entries used in adjusting the preliminary statements, and provide all schedules used in calculations. Prepare the appropriate disclosures and footnotes based upon information provided in the case. In some instances you will not have enough information to provide full disclosure.

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Summary of Selected Accounting Policies

Judgments and Estimates—Significant judgments and estimates are made in the preparation of the financial statements. These judgments and estimates include those related to asset valuation, accrued expenses, expected interest rates, and employee service lives, among others. Some of the more critical judgments and estimates are discussed in the following accounting policies.

Investments—Passive investments are classified upon acquisition as held-to-maturity, available-for-sale, or trading. The Company makes fair value adjustments as required and reviews initial classifications based on available information.

Property, Plant, and Equipment—Property, plant, and equipment are stated at cost and are depreciated over their estimated useful lives of 5 years for vehicles, 10 years for equipment, and 30 years for buildings, using the straight-line method of depreciation, with zero residual value. Capital leases are amortized using the straight-line method.

Impairments—The Company reviews its noncurrent assets and goodwill and performs annual impairment tests. No impairment losses were identified for 2012.

Taxes—Deferred taxes are provided for temporary differences between financial and tax reporting. The Company has accumulated substantial net operating loss carry-forwards in previous years and utilized the maximum net operating loss carry-forwards in the current year as allowed by law. The Company also records a valuation allowance to reduce its deferred tax assets to the amount that is more likely than not to be realized. Should the Company determine that it would (not) be able to realize more (less) of the deferred tax assets in the future, an adjustment to the deferred tax asset would be charged to income in the period such determination is made.

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Exhibit 1: Preliminary Financial Statements

	Omega Tech, Inc. Comparative Balance Sheets at December 31, 2012 and 2011		
		12/31/2012	12/31/2011
Assets			
	Cash	$72,000	$114,000
	Accounts receivable	$22,642	$35,073
	Prepaid expenses	$13,000	$11,000
	Deferred tax asset	$65,700	$65,700
	Investments	$65,000	$65,000
	Land	$200,000	$125,000
	Equipment	$250,000	$100,000
	less accumulated depreciation	($30,000)	($20,000)
	Vehicles	$37,000	$55,000
	less accumulated depreciation	$0	($10,000)
	Buildings	$535,000	$360,000
	less accumulated depreciation	($132,000)	($120,000)
	Construction in progress	$6,265,000	$2,545,000
	Patents	$50,000	$55,000
		$7,413,342	$3,380,773
Total Assets			
Liabilities	Accounts payable	$83,469	$75,000
	Salaries payable	$18,000	$11,000
	Noncurrent deferred tax liability	$56,100	$56,100
	Accrued pension liability	$10,000	$10,000
	Note payable-long term, 6 yr, 10%	$600,000	$600,000
	Mortgage payable, 6%	$3,200,000	$0
	10 year, 11% bonds payable	$3,000,000	$3,000,000
	Discount of bonds	($123,358)	($136,927)
	Construction loan, 12%	$1,200,000	$1,200,000
Total Liabilities		$8,044,211	$4,815,173
Stockholder's Equity			
	Common stock, no par	$1,734,000	$1,348,900
	OCI-Prior service cost	($30,000)	($30,000)
	Retained earnings	($2,334,869)	($2,753,300)
Total Liabilities and Stockholder's equity		$7,413,342	$3,380,773

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Case ID 030201

	Omega Tech, Inc. Income Statement for the year ended December 31, 2012	
Service revenue	$2,087,000	
Investment revenue	11,000	
Gain	70,000	
Total Revenues		$2,168,000
Salaries expense	$475,000	
Operating expense	203,000	
Depreciation expense	24,000	
Research and Dev. expense	82,000	
Pension expense	200,000	
Patent amort	5,000	
Lease expense	75,000	
Interest expense	679,569	
Miscellaneous exp	6,000	
Total Expenses		$1,749,569
Income before tax		$418,431

Exhibit 2 Pension information

Balances, January 1, 2012
Memo information

Pension Benefit Obligation	$840,000
Fair value of plan assets	$830,000

Balances, January 1, 2012
Balance sheet information

Accrued pension liability	$10,000
Other comprehensive Income-Prior Service Cost	$30,000

Pension expense information
For the year ended December 31, 2012

Service cost	$160,000
Interest rate	6%
Expected return on plan assets	6.2%
Actual return on plan assets	5.5%
Average remaining service life	10 years
Contributions	$200,000

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Exhibit 3 Deferred Tax information

(in thousands)

At December 31, 2011						
item	book value tax	book value gaap	difference	rate	def tax	classification
NOL			230,000	30%	69,000	CDTA
Fixed assets	243,000	365,000	(122,000)	30%	(36,600)	NCDTL
CIP-int cap	2,500,000	2,545,000	(45,000)	30%	(13,500)	NCDTL
Pension	0	20,000	(20,000)	30%	(6,000)	NCDTL
Prepaid expenses	0	11,000	(11,000)	30%	(3,300)	CDTL
			Totals	CDTA	65,700	
				NCDTL	(56,100)	
2012 amounts:						
Book value of assets for tax purpose		$470,000				
Tax rate in future periods		30%				

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