A Discussion of Twelve Financial Accounting Topics

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A DISCUSSION OF TWELVE FINANCIAL ACCOUNTING TOPICS

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.

Oxford
May 2019

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ABSTRACT

KATHERINE OGLESBY: A Discussion of Twelve Financial Accounting Topics
(Under the Direction of Dr. Victoria Dickinson)

The purpose of this paper is to investigate twelve different financial reporting topics using specific scenarios and financial positions of existing companies that have been presented in various case studies. The case studies cover multiple topics, long-term debt, equity sales, marketable securities, deferred income taxes, revenue recognition, financial reporting of cash flows, impairments and securities’ sales related to debt, and capitalized costs and earnings quality. In addition to the financial reporting topics, four cases cover various accounting-related topics, including data analytics incorporated into the profession as a whole, transparency and ethics both during the accounting recruiting process, along with during and after internships and starting full time, and an analysis of potential cities in which hold potential advantages and disadvantages for both interning in and starting full-time. Each individual financial case introduces a company whose financials and accounting position will be utilized for better understanding of the topic at hand. Following company introductions, the cases pose multiple questions to guide the reader through analysis of the topic. Through investigation and analysis of the companies presented in relation to the topics at hand, an understanding of generally accepted accounting principles in relation to the accounting topics is enhanced at both the journal entry level, along with at the company wide reporting level, as well as the implications that various issues with each topic can hold for companies.
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This case explores Tableau’s business intelligence software tool that helps users in multiple professions and industries make better business decisions. Just as information processing begins with collecting data, this case requires gathering facts about the tool and company behind this data-transforming software. By researching different versions of Tableau’s tool, I learned of the many mediums through which Tableau can be accessed and used, as it can connect to numerous types of databases and servers. Additionally, the tool can connect to multiple sources of data and generate dashboards or visualizations as a result of aggregation. Tableau includes features like instantaneous trend and regression analysis, data calculations, and geographic mapping all by just dragging and dropping. Tableau can easily be adopted by the accounting profession within audit, tax, and financial advisory services, as it has the potential to change the way data and transactions are analyzed, presented, and visualized as we know it.

Tableau would not only act as a tool for me to utilize as an accountant, but would also strengthen my skills in data visualizations and presentation. As Dale Carnegie stated in *How To Win Friends and Influence People in the Digital Age*, “in an age when the mass of messages multiples daily, only a small number really matter: to influence others, make sure yours are among them.” Tableau acts as the key to making one’s message matter, whether that be by acting as a visual of a resume or portfolio, or as acting as a visual aid to accounting services provided to future clients. Tableau would not only strengthen my technical skills to help me advance in my career, but would also equip me with the tools necessary to help assert my point across to others and to more effectively communicate my insights to others in hopes of them having better understandings of the data presented.
APPENDIX: Questions for Case Study 1

a. Identify the history and purpose of this tool and describe, in general, how it is used to make business decisions. Be specific about what kind of technology platform it uses, etc. and other resources that need to be in place to fully utilize the functionality of the tool.

Tableau, a software company based out of Seattle, offers a business intelligence software tool used for data analysis and interactive visualization to allow users to easily spot trends and visualize data for better decision making. The product originated as a result of a U.S. Department of Defense project at Stanford University to increase individuals’ abilities to analyze information. Tableau’s core technological language is VizQL, like SQL, that follows a visual syntax based off of dragging and dropping to communicate messages with trend analyses, regressions, and correlations. Today, the software has evolved to include features beyond standard data analysis and includes functions like mapping data into custom geography and access to the software through a mobile app. Tableau has desktop platforms for Mac (OS X 10.10 or later) and Windows (Windows 7 or later) and connects to data on-premises or in a digital cloud like Google Analytics and Salesforce that create interactive dashboards. The software is available in professional editions to access files, databases, and more, along with personal edition options to connect to files like Excel and Google Sheets. In addition to Tableau Desktop, users can access the product through Tableau Server, Tableau Online, and Tableau Public, the company’s free, cloud-based platform available
to bloggers, journalists, researchers, and government workers to visualize public data on Websites. Tableau supports a broad range of both professional and personal data sources like Athena, Aurora, EMR, PDF, Dropbox, Microsoft Office, MySQL, Teradata, Quickbooks, and SAP BW among numerous others that can be combined together for one or multiple interactive dashboards. The software is compatible with data stored in any language, but the interface and documentation are available in English, French, German, Spanish, Brazilian Portuguese, Japanese, Korean, and Simplified Chinese.

b. What special skills are needed to use this tool to aid in business decision making. How might a student like yourself gain those skills?

In order to fully utilize Tableau Software, one must have an understanding of a company’s data and database source to connect with the software and understand the data translation to visual analytics. Although Tableau offers answers to the questions of individuals analyzing data, those individuals must be skilled in their companies’ databases and languages or receive help from someone who does have knowledge of the database and can connect it to the software. For example, if an individual wanted to connect to a database that used SQL, one would need to be well-versed in SQL to connect the two sources. Moreover, one must have a general understanding of utilizing Tableau Server or Tableau Desktop to create visualizations. Tableau offers free one-year licenses to Tableau Desktop for students, along with free on-demand training videos, 24/7 desktop support, and starter kit guides to learn the basics of Tableau. To become more skilled with Tableau’s most striking features like mapping, data blending, and calculations,
Tableau offers free, one-hour, live online training sessions, too. Past webinars for multiple industries are also available on the company’s website that cover a plethora of topics like “5 Charts Every Sales Leader Should Be Looking At” to “Delivering Better Patient Care with Data at the Cleveland Clinic.” Tableau encourages its student users to utilize the tool to help in building portfolios, resumes, presentations, budgets, and extracurriculars. The company’s website offers free data sets to help students build their interactive dashboards. Overall, Tableau's website resources offer more than enough for students to gain exposure to and experience in utilizing business intelligence software.

c. How, specifically, would you use the tool in the following business settings?

Create at least three specific scenarios for each category in which the tool would lead to more efficiency and/or better effectiveness. Be sure to describe what kind of data your tool would use for each scenario.

i. Auditing

Tableau Software could be used within a firm to help with audit compliance and audit issues that have been identified not only by external auditors or regulators, but also internal staff. By being able to summarize, communicate and analyze the issues that are reported from auditing, a firm would be able to more quickly generate more accurate reporting. Data sources needed would include audit reports and evaluations, along with the financial statements and other reports utilized within specific audits. Utilizing Tableau would allow for more effective results after internal and external audits, as businesses would be able to visualize the sources of
compliance and auditing issues, and analyze these issues on a deeper level, leading to more timely outcomes. The tool could also be used during audits to help identify fraud within a company. Tableau would be able to isolate outliers, discrepancies, or unusual transactions from data sources like cash disbursements, payment schedules, or the general ledger. This would lead to more effective auditing services. More importantly, Tableau would allow auditors to explore all of the transactions within the general ledger and other related data within a company instead of being limited by audit sampling due to time constraints. This would lead to more efficient and timely services and allow for a firm to provide services within a timely manner that would not be possible without a high-speed data analytics tool like Tableau.

ii. **Tax Planning**

By utilizing the geographical region and mapping features of Tableau, tax services will be able to provide more accurate, detailed estimates at local, state, federal and international levels for clients. The software would be able to generate these estimates based off of clients’ tax returns and identify the best strategies for companies in multiple locations. This would allow for more effective decision making and tax planning through more insightful visualizations. Tableau software creates opportunities for tax planning services to provide tailored workbooks for individual clients in more timely fashions. Organizers would show the most favorable tax positions and be able to communicate areas of savings and investment for
client’s money after analyzing tax returns and other client information through the software. As 2017 ended with the signing of President Trump’s tax plan, Tableau can communicate to clients the most effective tax planning strategies under the new tax provisions that came into effect on January 1 of 2018. Even more so, Tableau will help accountants and clients to better understand the potential effects of specific tax planning under the new laws.

iii. **Financial Statement Analysis & Valuation**

Tableau’s business intelligence software has the potential to manipulate financial statements to analyze and identify areas of high growth and risk within a firm. By looking at sources of net profits and net losses and identifying reasons why these situations occur will allow for better decision making in the future to maximize profits. Tableau would create visuals for users through its mapping features to pinpoint those specific areas of growth and risk, too. Additionally, the tool could be used in comparing actual results from financial statements versus budgeted results and conveying the variances and reasons for the variances. The software would be able to generate these discrepancies from the master budget and actual financial reports and schedules in a more timely manner than conventional methods offer, too. Since Tableau Software has the ability to generate dashboards and visualizations from multiple data sources, the tool would not only add value to financial statement analysis for one specific quarter or fiscal year, but be able to compare multiple months,
quarters, and years, along with comparing those periods of time to the budgeted projections. This would allow users to identify areas of budget changes and outliers, along with outliers and changes in actual outcomes. For companies with multiple reporting locations, the software would allow for overall comparison, along with location-specific comparison for analysis to result in more effective and efficient decision-making.

d. Write to your future public accounting partner explaining why your team should invest in the acquisition of and training in this tool. Explain how the tool will impact the staffing and scope of your future.

Tableau’s business and intelligence software offers a myriad of possibilities for insights and understanding to the data our company analyzes and interacts with every day. Tableau would not only save time in auditing, tax planning, and financial statement advisory, but would elevate the expectations and standards of how numbers appeal to the eye of clients. More than just appealing to the eye, though, is the fact that Tableau Software can create dashboards, visualizations, and business intelligence insights within seconds of connecting to data. Insights can be found faster and explored in new and deeper ways compared to Excel or other programs. Investing in this tool would expand our capabilities as public accountants in auditing by being able to analyze and review compliance and auditing issues within our company. Additionally, when performing auditing services for clients, our company would be able to not only perform audit sampling, but with Tableau, we would be able to analyze all data and all transactions with the general ledger because of how timely Tableau is with data
processing. This would allow for more effective identification of unusual transactions, fraud, or compliance issues within other companies. Moreover, the software tool would allow us to expand our tax planning services by creating client-tailored dashboards and workbooks, with new and enhanced features like geographical mapping for different financial planning strategies and would allow us to keep up with the changing times of tax laws and still effectively deliver our services to clients. Finally, Tableau would create a new visual for financial statement analysis and advisory through interactive exploration and examination of variances, discrepancies, and results. Although the tool would generate expenses for usage and training of the software, Tableau’s website offers a multitude of free online resources to assist in training. Additionally, the company offers self-paced eLearning courses for the company to invest in to develop more skills with the software. While offering feedback and assessments for training, investing in this tool would be highly cost-effective and allow for full understanding and manipulation of Tableau’s software and tools. Tableau Software will help us answer more of our questions and create new questions for further exploration, all while saving time and helping us deliver more effective and appealing services to our clients. Thus, an investment in Tableau Software is an investment in better insights.
CASE 2: LONG-TERM DEBT
Rite Aid Corporation

February 14, 2018
This case required examining the financial statements of the third largest U.S. retail pharmacy, Rite Aid, to gain a greater understanding of the different types of debt a company can issue to finance different needs. Rite Aid has both secured and unsecured debt, with a portion of its unsecured debt being guaranteed by the subsidiaries of Rite Aid. Additionally, some of its long-term debt has priority over others and is denoted by the term “senior,” while a portion of its debt has a fixed interest-rate, along with some of the long-term debt being convertible into common stock. After taking a closer look at Rite Aid’s balance sheets and debt disclosures in the accompanying notes, I was able to differentiate between the its different types of debt, the accounting treatment for each type, and what each type of debt implies for its assets, expenses, liabilities, and income now and in the future. By understanding the accounting treatment and reporting requirements for long-term debt, I will be able to better perform my duties as an accountant and an auditor in the future.
a. Consider the various types of debt described in note 11, Indebtedness and Credit Agreement.

i. Explain the difference between Rite Aid’s secured and unsecured debt. Why does Rite Aid distinguish between these two types of debt?

Rite Aid’s secured debt is backed by and tied to specific assets of the company that have been pledged as collateral in the event that Rite Aid is unable to pay off its debt at maturity. On the other hand, Rite Aid’s unsecured debt is not backed by assets that have pledged as collateral. Rite Aid distinguishes between these two types of debt because the two classes of debt represent different levels of risk and interest rates. In the event that Rite Aid is unable to pay off its debt, financial statement users, such as investors or creditors, would need to know how much of Rite Aid’s debt is guaranteed by its assets. If Rite Aid were to default on its secured loans, this would decrease the company’s assets.

ii. What does it mean for debt to be “guaranteed”? According to note 11, who has provided the guarantee for some of Rite Aid’s unsecured debt?

Debt can be “guaranteed” if a third party agrees to complete payment of and be responsible for another company’s debt if its fails to provide payment for its debt. Rite Aid has “guaranteed” unsecured debt that is not
backed by collateral but guaranteed to be paid off by the firm’s wholly-owned subsidiaries.

iii. **What is meant by the terms “senior,” “fixed-rate,” and “convertible”?**

Debt that is denoted as “senior” has priority to be paid off first over other debt in the event of bankruptcy or liquidation. Rite Aid has both senior secured debt and senior unsecured debt. Fixed-rate implies that the associated debt has an interest rate that does not change over the term of the debt. Rite Aid has one unsecured unguaranteed senior note with a fixed-rate of 6.875 percent. Another feature of long-term debt is that it can be “convertible,” meaning the bond can be converted into other securities such as common stock if certain conditions are met. Rite Aid has 8.5 percent unsecured notes “convertible, at the option of the holder, into shares of the Company’s common stock at a conversion price of $2.59 per share, subject to adjustments to prevent dilution, at any time.”

iv. **Speculate as to why Rite Aid has many different types of debt with a range of interest rates.**

Rite Aid has a myriad of debt of different, all with ranging interest rates, to diversify the ways in which the company can finance its assets. The interest rates differ because not all of the debt is issued at the same time. Market rates are constantly changing, which affect the stated rates, too. Rite Aid does not have just one type of debt, such as secured debt, because then it would be limited by the amount of assets the company held. The different interest rates affect Rite Aid’s assets, liabilities and income.
because the rates affect the amount of cash interest paid each period, along with the amount of accrued interest if not paid. Moreover, the interest rates affect the amount of interest expense for each period which decreases revenues and affects the amount of income the company retains.

b. Consider note 11, Indebtedness and Credit Agreement. How much total debt does Rite Aid have at February 27, 2010? How much of this is due within the coming fiscal year? Reconcile the total debt reported in note 11 with what Rite Aid reports on its balance sheet?

At February 27, 2010, Rite Aid’s total debt is $6,370,899. $51,502 of the $6,370,899 is the current portion due within the coming year. On its balance sheet, Rite Aid reports that lease financing obligations equate to $152,691, which is added to the total debt, while long-term debt and lease finance obligations, less current matures equates to $6,319,397. The total debt in note 11 is the sum of the currently maturing portion of long-term debt, the long-term debt, and the lease financing obligations.

c. Consider the 7.5 percent senior secured notes during March 2017.

i. What is the face value (i.e. the principal) of these notes? How do you know?

The face value of the 7.5 percent senior secured notes due March 2017 is $500,000. This is known because it is noted in note 11, along with the fact that the face value of a note does not change over time unless the face value of the note was reduced when modifying the terms of the note.
ii. Prepare the journal entry that Rite Aid must have made when these notes were issued.

\[
\begin{align*}
\text{Cash} & \quad 500,000 \\
\text{Bonds Payable} & \quad 500,000
\end{align*}
\]

This entry increases the company’s current assets, specifically cash, while also increasing the company’s liabilities, specifically the amount of long-term debt.

iii. Prepare the annual interest expense journal entry. Note that the interest paid on a note during the year equals the face value of the notes times the stated rate (i.e., coupon rate) of the note.

\[
\begin{align*}
\text{Interest Expense} & \quad 37,500 \\
\text{Cash} & \quad 37,500
\end{align*}
\]

This entry decreases the amount of assets of Rite Aid. The charge to income expense decreases Rite Aid’s income, as well.

iv. Prepare the journal entry that Rite Aid will make when these notes mature in 2017.

\[
\begin{align*}
\text{Bonds Payable} & \quad 500,000 \\
\text{Cash} & \quad 500,000
\end{align*}
\]

The entry to record the maturity of this debt will decrease the company’s assets as it pays off the bond payable with cash, but will also decrease the amount of liabilities reported on Rite Aid’s balance sheet.

d. Consider the 9.375 percent senior notes due December 2015. Assume that interest is paid annually.
i. What is the face value (or principal) of these notes? What is the carrying value (net book value) of these notes at February 27, 2010? Why do the two values differ?

The face value of the 9.375 percent notes due December 2015 is $410,000. The carrying value of these notes at February 27, 2010 is $405,951. These two values differ because the notes were issued at a discount, which will be amortized over the life of the notes, with only a portion of the discount being amortized up to February 27, 2010. Since the note is issued at a discount, this decreases the amount of cash proceeds Rite Aid receives when it issues the notes. When the notes are issued at discounts, the Discount on Bonds Payable account will be debited, which is a contra-liability account. The amount of unamortized discount on the bonds affects the bonds’ book value. When a portion of the discount is amortized each period, the contra-liability account will be credited and the amount of interest expense recorded will be greater than the cash interest paid. This increases the amount of total expense and will affect Net Income on Rite Aid’s Income Statement.

ii. How much interest did Rite Aid pay on these notes during the fiscal 2009?

Rite Aid paid cash interest of $38,438 during the fiscal 2009. When Rite Aid pays cash interest each period, the amount of cash in Rite Aid is decreased by that amount and the interest expense is recorded, which decreases income.
iii. Determine the total amount of interest expense recorded by Rite Aid on these notes for the year ended February 27, 2010. Note that there is a cash and a noncash portion to the interest expense on these notes because they were issued at a discount. The noncash portion of interest expense is the amortization of the discount during the year (that is, the amount by which the discount decreased during the year).

Rite Aid’s total interest expense for the year ended February 27, 2010 is $39,143. $38,438 of this is the cash interest paid, while the remaining $705 is the amortized discount. The amortized discount will be added to the carrying value of the debt.

iv. Prepare the journal entry to record interest expense on these notes for fiscal 2009. Consider both the cash and discount (noncash) portion of the interest expense from part iii above.

\[
\begin{align*}
\text{Interest Expense} & \quad 39,143 \\
\text{Discount on Bonds Payable} & \quad 705 \\
\text{Cash} & \quad 38,438
\end{align*}
\]

This entry increases the amount of expense reported, while decreasing the amount in its cash account. The interest expense will decrease income on the Income Statement. The amortized discount will be added to the carrying value of the bond, yet total liabilities does not change.
v. **Compute the total rate of interest recorded for fiscal 2009 on these notes.**

The total rate of interest for fiscal 2009 on the 9.375 percent senior notes is 9.64 percent. The total rate of interest recorded on these notes affects the amount of interest expense recorded, which will affect reported income.

e. **Consider the 9.75 percent notes due June 2016. Assume that Rite Aid issued these notes on June 30, 2009 and that the company pays interest on June 30th of each year.**

i. **According to note 11, the proceeds of the notes at the time of issue were 98.2 percent of the face value of the notes. Prepare the journal entry that Rite Aid must have made when these notes were issued.**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>402,620</td>
</tr>
<tr>
<td>Discount on Notes Payable</td>
<td>7,380</td>
</tr>
<tr>
<td>Notes Payable</td>
<td>410,000</td>
</tr>
</tbody>
</table>

This entry increases the amount of cash Rite Aid now has, while also increasing its amount of liabilities. The discount will be amortized over the life of the notes, increasing the carrying value of the notes each period, as it is included in the amount of interest expense each period.

ii. **At what effective annual rate of interest were these notes issued?**

   The notes were issued at an effective rate of 10.1212 percent. The effective rate will affect how much interest expense is reported each period, regardless of the amount of cash interest paid each period.
iii. Assume that Rite Aid uses the effective interest rate method to account for this debt. Use the table that follows to prepare an amortization schedule for these notes. Use the last column to verify that each year’s interest expense reflects the same interest rate even though the expense changes.

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash Interest Payment</th>
<th>Interest Expense</th>
<th>Bond Discount Amortization</th>
<th>Net Book Value of Debt</th>
<th>Effective Interest Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>6/30/2009</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>$402,620.00</td>
<td>10.12 percent</td>
</tr>
<tr>
<td>6/30/2010</td>
<td>$39,975</td>
<td>$40,750.00</td>
<td>$775.00</td>
<td>$403,395.00</td>
<td>10.12 percent</td>
</tr>
<tr>
<td>6/30/2011</td>
<td>$39,975</td>
<td>$40,823.57</td>
<td>$848.57</td>
<td>$404,243.57</td>
<td>10.12 percent</td>
</tr>
<tr>
<td>6/30/2012</td>
<td>$39,975</td>
<td>$40,909.45</td>
<td>$934.45</td>
<td>$405,178.02</td>
<td>10.12 percent</td>
</tr>
<tr>
<td>6/30/2013</td>
<td>$39,975</td>
<td>$41,004.02</td>
<td>$1,029.02</td>
<td>$406,207.04</td>
<td>10.12 percent</td>
</tr>
<tr>
<td>6/30/2014</td>
<td>$39,975</td>
<td>$41,108.15</td>
<td>$1,133.15</td>
<td>$407,340.19</td>
<td>10.12 percent</td>
</tr>
<tr>
<td>6/30/2015</td>
<td>$39,975</td>
<td>$41,222.83</td>
<td>$1,247.83</td>
<td>$408,588.02</td>
<td>10.12 percent</td>
</tr>
<tr>
<td>6/30/2015</td>
<td>$39,975</td>
<td>$41,111.98</td>
<td>$1,411.98</td>
<td>$410,000.00</td>
<td>10.12 percent</td>
</tr>
</tbody>
</table>

iv. Based on the above information, prepare the journal entry Rite Aid would have recorded February 27, 2010, to accrue interest expense on these notes.

```
Interest Expense  27,167
Discount on Notes Payable   517
Cash  26,650
```

This entry increases the amount of interest expense reported by Rite Aid, while decreasing the amount in its cash account. The interest expense will be reported on the Income Statement and will ultimately decrease income.
The amortized discount will be added to the carrying value of the notes, yet the amount of total liabilities does not change.

v. Based on your answer to part iv., what would be the net book value of these notes at February 27, 2010?

The net book value at February 27, 2010 is $403,137. The amount of liability reported by Rite Aid will not be affected by the change in carrying value, though.
This case examined Merck & Co., Inc., a global research-driven pharmaceutical company, while specifically focusing on its Shareholders’ Equity and the associated disclosures. The case provided Merck’s Consolidated Statement of Income, Consolidated Statement of Retained Earnings, Consolidated Balance Sheet, and Consolidated Statement of Cash Flows, along with notes to the consolidated statements. After considering Merck & Co.’s common shares, I found that the pharmaceutical company had roughly 2,983.51 million shares issued of its 5,400 million shares authorized, equating to roughly $29,835.08 million. During 2007, Merck had purchased roughly 26.5 million shares, which reduces the amount of shares outstanding. These stock buybacks could have occurred for a plethora of reasons. Perhaps, the company believed its shares were undervalued and hoped to reissue them when the market value per share was more favorable, or it hoped to increase earnings per share. Merck & Co. has declared roughly $3,310.7 million in dividends on common stock, which reduces the amount in Retained Earnings. Since this dividend was a dividend on common stock and was paid in part with cash, the par value per share did not change. Finally, the case asked for calculations involving dividends, such as Merck’s dividends per share for both 2006 and 2007, which increased from $1.52 to $1.53. Although Merck paid less dividends and earned a lower net income in 2007 compared to the prior year, its dividend payout was greater.
a. Consider Merck’s common shares.

i. How many common shares is Merck authorized to issue?

Merck has authorized 5,400,000,000 shares to issue.

ii. How many common shares has Merck actually issued at December 31, 2007?

At December 31, 2007, Merck had issued 2,983,508,675 shares.

iii. Reconcile the number of shares issued at December 31, 2007, to the dollar value of common stock reported on the balance sheet.

$29,835.08 million.

iv. How many common shares at held in treasury at December 31, 2007?

811,005,791 common shares are held in treasury.

v. How many common shares are outstanding at December 31, 2007?

2,172,502,704 common shares are outstanding.

vi. At December 31, 2007, Merck’s stock price closed at $57.61 per share.

Calculate the market capitalization of Merck on that day.

$125,157.88 million.
b. Why do companies pay dividends on their common or ordinary shares?

What normally happens to a company’s share price when dividends are paid?

Companies pay dividends on common shares as a return to stockholders on their investment in the company. When dividends are paid, whether they are cash or stock, a company’s retained earnings is reduced by the total dividend amount. When stock dividends are paid, share price does not change. However, when a stock split is declared and new shares are issued, the share price is reduced, as the total par amount is allocated among an increased amount of shares.

c. In general, why do companies repurchase their own shares?

Stock buybacks can occur if a business believes their own shares are undervalued, then will reissue the shares as the market value has increased again. Additionally, when a company repurchases its own shares, the number of shares outstanding is reduced, thus increasing earnings per share.

d. Consider Merck’s statement of cash flow and statement of retained earnings.

Prepare a single journal entry that summarizes Merck’s common dividend activity for 2007.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained Earnings</td>
<td>3,310,700,000</td>
</tr>
<tr>
<td>Dividends Payable</td>
<td>3,400,000</td>
</tr>
<tr>
<td>Cash</td>
<td>3,307,300,000</td>
</tr>
</tbody>
</table>
e. During 2007, Merck repurchased a number of its own common shares on the open market.

i. Describe the method Merck uses to account for its treasury stock transactions.

Merck uses the cost method to account for its treasury stock transactions, meaning it records the treasury stock at the market price at which they repurchased the shares.

ii. Refer to note 11 to Merck’s financial statements. How many shares did Merck repurchase on the open market during 2007?

26.5 million shares

iii. How much did Merck pay, in total and per share, on average, to buy back its stock during 2007? What type of cash flow does this represent?

Treasury stock repurchases are a financing activity. Merck paid a total of $1,429.7 million to repurchase its stock, which is equivalent to $53.95 per share.

iv. Why doesn’t Merck disclose its treasury stock as an asset?

An asset is something a company owns that has future economic value that can be both measured and expressed in dollars. Although treasury stock has future economic value in the form of cash from reissuance, there is no economic gain. Instead, treasury stock simply reduces a company’s number of ordinary shares outstanding, as it is a contra equity account.
f. Determine the missing amounts and calculate the ratios in the tables below.

For comparability, use dividends paid for both companies rather than dividends declared. Use the number of shares outstanding at year end for per-share calculations. What differences do you observe in Merck’s dividend-related ratios across the two years? What differences do you observe in the two companies’ dividend related ratios?

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends Paid</td>
<td>$3,307.3 million</td>
<td>$3,322.6 million</td>
</tr>
<tr>
<td>Shares Outstanding</td>
<td>2,172.5 million shares</td>
<td>2,167.8 million shares</td>
</tr>
<tr>
<td>Net Income</td>
<td>$3,275.4 million</td>
<td>$4,433.8 million</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$48,350.7 million</td>
<td>$44,569.8 million</td>
</tr>
<tr>
<td>Operating Cash Flows</td>
<td>$6,999.2 million</td>
<td>$6,765.2 million</td>
</tr>
<tr>
<td>Year-End Stock Price</td>
<td>$57.61</td>
<td>$41.94</td>
</tr>
<tr>
<td>Dividends Per Share</td>
<td>$1.52 per share</td>
<td>$1.53 per share</td>
</tr>
<tr>
<td>Dividend Yield</td>
<td>2.64 percent</td>
<td>3.65 percent</td>
</tr>
<tr>
<td>Dividend Payout</td>
<td>1.01</td>
<td>0.75</td>
</tr>
<tr>
<td>Dividends to Total Assets</td>
<td>6.84 percent</td>
<td>7.45 percent</td>
</tr>
<tr>
<td>Dividends to Operating Cash Flows</td>
<td>47.25 percent</td>
<td>49.11 percent</td>
</tr>
</tbody>
</table>
This case analyzed the marketable securities of State Street Corporation, a global financial services company that is the second oldest financial institution in the United States, through its provided financial statements for the years 2011-2012. State Street has two primary business operations—Investment Servicing and Investment Management. Its main sources of revenue include revenue from trading services, management services, and from interest received on investments. The financial services institution’s assets and liabilities are presented on its’ Consolidated Statement of Condition for 2011-2012 in order of decreasing liquidity, with its trading securities being the most liquid of the three types of investment securities the corporation holds, which include available-for-sale and held-to-maturity securities, in addition to trading securities. Since State Street holds all three types of securities, each type of securities requires a different accounting methodology. Additionally, each security poses the opportunity to appear on each of the three given financial statements provided for State Street—the income statement, balance sheet, and statement of cash flows—through a variety of accounts depending on the type of the marketable securities.

This case offered the opportunity to have a better understanding of securities classified as trading, available-for-sale, and held-to-maturity through review of financial statements and analysis of footnote disclosures and supplemental information. As is evident in State Street’s financials, marketable securities offer the opportunity for companies, as they have the potential to greatly impact the bottom line. As a result of my work with this case, I will be able to better differentiate among marketable securities and will have a better understanding of which investments offer better opportunities for growth.
a. Consider trading securities. Note that financial institutions such as State Street typically call these securities “Trading account assets.”

i. In general, what are trading securities?

Trading securities are securities purchased in connection with trading activities and are expected to be sold in the near term. Trading securities are recorded at cost can be either debt or equity investments, and are adjusted based on the current fair market value of the security. These adjustments are recorded as unrealized holding gains or losses and directly affect income and result in the creation of a Fair Value Adjustment account.

ii. How would a company record $1 of dividends or interest received from trading securities?

Cash 1
   Dividend Revenue 1
Cash 1
   Interest Revenue 1

iii. If the market value of trading securities increased by $1 during the reporting period, what journal entry would the company record?

Trading Account Assets 1
   Unrealized Holding Gain/Loss—Income 1
b. Consider securities available-for-sale. Note that State Street calls these, “Investment securities available for sale.”

i. In general, what are securities available-for-sale?

Available-for-sale securities are debt and equity securities purchased with the intent of selling before reaching maturity, but not as quickly as trading securities. These securities are intended to be held for an indefinite period of time. Available-for-sale securities are reported at fair market value, with changes in market value being recognized as unrealized holding gains or losses that increase or decrease comprehensive income and result in the creation of a Fair Value Adjustment account.

ii. How would a company record $1 of dividends or interest received from securities available-for-sale?

Cash 1

Dividend Revenue 1

Cash 1

Interest Revenue 1

iii. If the market value of securities available-for-sale increased by $1 during the reporting period, what journal entry would the company record?

Investment Securities—Available-for-Sale 1

Unrealized Holding Gain/Loss—OCI 1
c. Consider securities held-to-maturity. Note that State Street calls these, “Investment securities held to maturity.”

i. In general, what are these securities? Why are equity securities never classified as held-to-maturity?

Held-to-maturity securities are debt securities purchased with the ability and intention of holding to the maturity date. Equity investments cannot be classified as held-to-maturity securities because equity securities do not have maturity investments. These securities, like both trading and available-for-sale, are initially recorded at cost and adjusted for by amortizing premiums or discounts. Held-to-maturity securities, unlike available-for-sale and trading securities, are not adjusted for based on market value changes.

ii. If the market value of securities held-to-maturity increased by $1 during the reporting period, what journal entry would the company make?

No entry recorded.

d. Consider the “Trading account assets” on State Street’s balance sheet.

i. What is the balance in this account on December 31, 2012? What is the market value of these securities on that date?

On December 31, 2012, the balance in the “Trading Account Assets” is $637,000,000. This amount is also the market value of the Trading account assets, as they are recorded at fair value in State Street’s books.
ii. Assume that the 2012 unadjusted trial balance for trading account assets was $552 million. What adjusting journal entry would State Street make to adjust this account to market value (in millions)? Ignore any income tax efforts for this part.

Trading Account Assets \[85\]
Unrealized Holding Gain/Loss—Income \[85\]

e. Consider the balance sheet account “Investment securities held to maturity” and the related disclosures in Note 4.

i. What is the 2012 year-end balance in this account?

The 2012 year-end balance in the account is $11,379,000,000.

ii. What is the market value of State Street’s investment securities held to maturity?

The market value of State Street’s securities held to maturity is $11,661,000,000.

iii. What is the amortized cost of these securities? What does “amortized cost” represent? How does amortized cost compare to the original cost of the securities?

The amortized cost of these securities is $11,379,000,000, which represents the adjusted amount of the original cost when taking into account any discounts or premiums associated with the security. Amortized cost can be referred to as the book value of the securities, while the original cost is the amount paid on the acquisition date. The amortized cost will be adjusted for at the end of each period until it amounts to the face value of the securities. Whether the securities were purchased at a
premium or discount will dictate whether the amortized cost is more or less than the original cost.

iv. What does the difference between the market value and the amortized cost represent? What does the difference suggest about how the average market rate of interest on held-to-maturity securities has changed since the purchase of the securities held by State Street?

The difference between the market value and the amortized cost represents the unrealized holding gains and losses on trading and available-for-sale securities that have occurred. The market value is the amount at which the investment would sell for if were to be sold in the market at a given point. The amortized cost is the carrying value of the investment, which is based off of the original cost and the amortization of any discount or premium. Since market value is greater than amortized cost, the investments are worth more than the amount that they are carried at on State Street’s books. Therefore, one can assume that the average market rate of interest on held-to-maturity securities has decreased below the investments’ interest rate since the purchase of these securities.
f. Consider the balance sheet account “Investment securities available for sale” and the related disclosures in Note 4.

i. **What is the 2012 year-end balance in this account? What does this balance represent?**

The 2012 year-end balance in “Investment securities available for sale” is $109,682,000,000, which represents the fair market value of the securities at year-end.

ii. **What is the amount of net unrealized gains or losses on the available-for-sale securities held by State Street at December 31, 2012? Be sure to note whether the amount is a net gain or loss.**

$1,119,000,000.

iii. **What was the amount of net realized gains (losses) from sales of available-for-sale securities for 2012? How would this amount impact State Street’s statements of income and cash flows for 2012?**

The net realized gain from sales of the available-for-sale securities for 2012 is $55,000,000. This amount impacts State Street’s statement of income, as it would appear on the income statement under “Gains (losses) related to investment securities,” and impacts the cash flow statement, as it would be included in the investing section as an increase for 2012.
g. State Street’s statement of cash flow for 2012 (not included) shows the following line items in the “Investing Activities” section relating to available-for-sale securities (in millions):

- Proceeds from sales of available-for-sale securities $5,399
- Purchase of available-for-sale securities $60,812

i. Show the journal entry State Street made to record the purchase of available-for-sale securities for 2012.

```
Investment securities available-for-sale  60,812
Cash                                      60,812
```

ii. Show the journal entry State Street made to record the sale of available-for-sale securities for 2012. Note 13 (not included) reports that the available-for-sale securities sold during 2012 had “unrealized pre-tax gains of $67 million as of December 31, 2011.”

```
Cash                                             5,399
Unrealized holding gain/loss—Equity             67
  Gain on sale of investment                      55
  Investment securities available-for-sale      5,411
```

iii. Use the information in part g. ii to determine the original cost of the available-for-sale securities sold during 2012.

The original cost of these securities was $5,344 (in millions). This can be determined by subtracting the realized gain from the sale of the investment from the cash proceeds from the sale ($5,399 - $55 = $5,344).
CASE 5: DEFERRED INCOME TAXES
ZAGG, Inc.

April 11, 2018
ZAGG, Inc.—Zealous About Great Gadgets—is a publicly traded, consumer electronics company that is specifically known for being a market leader in mobile device accessories. Through the analysis of ZAGG’s 2012 financial statements and footnotes, I was able to visualize how the temporary differences between accounting for taxable income and accounting for financial statements and book income give rise to deferred tax assets and deferred tax liabilities on the balance sheet. The footnotes of ZAGG’s financial statements give insight into the components of its income tax provision, which includes both current and deferred provisions, along with the specific components that give rise to its deferred tax assets and liabilities and the changes in those deferred tax liabilities and deferred tax assets, from both reversals and the valuation allowance, from year-to-year. Additionally, a better understanding of the specific components of the deferred tax accounts resulted pertaining to what comprised total balances and net effects, and balance sheet classifications.

This case offered the opportunity for increased exposure and experience in dealing with the financial statements of companies and the way in which their deferred income taxes and the components thereof are presented and disclosed for users. This case strengthened my knowledge of accounting for income taxes. This strong foundation will be useful in both my professional and personal life, especially in light of the changes that will be in effect from the Tax Cuts and Jobs Act of 2017, as an even better understanding of key concepts and fundamentals will be needed for deferred income taxes.
a. Describe what is meant by the term book income? Which number in ZAGG’s statement of operations captures this notion for fiscal 2012? Describe how a company’s book income differs from its taxable income.

Book income is also known as pretax financial income or income before income taxes. Book income is shown on a company’s income statement and is determined according to generally accepted accounting principles (U.S. GAAP) to provide useful information to investors and creditors. In ZAGG’s statement of operations, its book income, $23,898,000, is captured by the term “income before provision for income taxes.” Taxable income differs from book income as a result of temporary and permanent differences and is the income that is subject to taxes in the form of income taxes payable. Rather than being determined by U.S. GAAP, taxable income is determined according to the Internal Revenue Service’s tax code.

b. In your own words, define the following terms:

i. Permanent tax differences (also provide an example):

Permanent tax differences are differences between book income and taxable income that result from items that either enter into pretax financial income but never into taxable income, or enter into taxable income but never into pretax financial income. Therefore, these differences will never reverse. This can occur because certain tax laws exempt specific revenues and expenses from either taxable income or pretax financial income.
Examples of items that are not recognized for tax purposes, but are recognized for financial reporting purposes includes interest received on municipal bonds and fines or expenses resulting from violations of the law. Items that are recognized for tax purposes only and never for financial reporting purposes include deductions for dividends received from U.S. corporations, along with percentage depletion of natural resources in excess of their cost.

ii. **Temporary tax differences (also provide an example):**

Temporary tax differences are any differences between book income and taxable income that originate from timing differences and will eventually reverse. A temporary tax difference can result in either future taxable amounts, which increase taxable income in future years, or future deductible amounts, which decrease taxable income in the future. However, since these differences reverse, they will be recognized and reflected in both pretax financial income and taxable income at some point or over multiple periods. An example of a revenue that will result in future taxable amounts is sales accounted for on an accrual basis for financial reporting purposes and on a cash basis for tax purposes. An example of a revenue that will result in a future deductible amount are subscriptions or rental receipts received in advance.

Expenses that result in future taxable amounts include depreciable property, while expenses that result in future deductible amounts can include product warranty liabilities. Future taxable and future deductible
amounts result in the creation of deferred tax accounts. Future taxable amounts result in the creation of a deferred tax asset account, which represents the deferred tax consequences attributable to deductible temporary differences and carryforwards. On the other hand, future deductible amounts result in the creation of a deferred tax liability account, which represents the deferred tax consequences attributable to taxable temporary differences. Deferred tax liabilities and assets can be classified as current or noncurrent based on the classification of the related asset or liability for financial reporting. If there is no associated asset or liability or if the temporary difference will reverse only over a period of time, the deferred tax liability or asset would be classified based on the expected reversal date of the specific temporary difference. Also, both are measured using the applicable enacted tax rate and provisions of the enacted tax law.

iii. **Statutory tax rate:**

The statutory tax rate is the tax rate mandated by either federal or state law, or both.

iv. **Effective tax rate:**

The effective tax rate is the rate that can be calculated by dividing income tax expense by pretax financial income. This rate gives the percentage of income that was actually paid for in taxes. The effective tax rate can differ from the statutory, or enacted, tax rate if permanent differences exist or if the statutory rate changes for any periods involved.
c. Explain in general terms why a company reports deferred income taxes as part of their total income tax expense. Why don’t companies simply report their current tax bill as their income tax expense?

ASC 740-10 highlights income statement related disclosures that are now required by companies. Instead of companies simply reporting their current tax bill as their income tax expense, they are required to disclose and include significant components of income tax expense, which include the current tax expense (or benefit), along with the deferred tax expense (or benefit). The current tax expense is the current amount of income taxes paid or payable (or refundable) for a year as determined by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues for that year. The deferred tax expense is the change during the year in an entity’s deferred tax liabilities and assets. The deferred portion can also be thought of as the net tax effects of the timing differences that result in the creation of deferred tax assets and deferred tax liabilities. Total income tax expense is the sum of both the current tax expense and deferred tax expense. Income tax expense for the year is allocated among continuing operations, discontinued operations, and items charged or credited directly to shareholders’ equity.

In addition to ASC 740, which covers the topic of Income Taxes, Regulation S-X Rule 4-08(h) of the Securities and Exchange Commission specifies required disclosures related to income taxes. These specific requirements are parallel to ASC 740 and mandate that disclosures shall be made in the income statement or in a note thereto of the components of income tax expense, including
taxes currently payable and the net tax effects of timing differences. Additionally, within in the income statement or notes thereto, the amount of the estimated tax effect of each of the various types of timing differences must be indicated. The disclosure of deferred income taxes as part of a company’s total income tax expense can help users make better predictions of future cash flows and can help provide information as to whether taxes payable are likely to be higher or lower in the future. Reporting deferred income taxes allows users to know what a company will be expected to pay for in the future and provides a more accurate picture of a company’s overall financial position. Because the existence of deferred income taxes implies that these taxes will be paid in following periods, companies should account for them once aware of their existence, just as they would do so when becoming aware of other future liabilities that will require payment in subsequent periods.

d. Explain what deferred income tax assets and deferred income tax liabilities represent. Give an example of a situation that would give rise to each of these items on the balance sheet.

Conceptually, a deferred income tax asset or liability represents the decrease or increase in taxes payable or refundable in future years as a result of temporary differences and carryforwards—deductions or credits that cannot be utilized on the tax return during a year that may be carried forward to reduce taxable income or taxes payable in a future year—at the end of the current year. Deferred income tax assets are the deferred tax consequences attributable to deductible temporary differences and carryforwards. These “deferred tax
consequences” imply future effects on income taxes. Deferred tax assets are measured using the applicable enacted tax rate and provisions of the enacted tax law. A deferred tax asset is reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

Deferred income tax liabilities represent the deferred tax consequences attributable to taxable temporary differences. Deferred tax liabilities are also measured using the applicable tax rate and provisions of the enacted tax law. A deferred tax liability may be recognized when revenue or gains will result in future taxable amounts when an asset is recovered. For example, a receivable from an installment sale would result in the creation of a deferred tax liability that will be reversed when the receivable is collected for the sale. When payment is collected and the deferred tax liability is reversed, the amount collected will be taxable. Similarly, a deferred tax liability is recognized when a company uses an accelerated depreciation method for tax purposes. Therefore, its depreciation expense for tax purposes would be greater than its depreciation expense for financial reporting purposes, resulting in financial reporting income being greater than taxable income. Overall, deferred tax liabilities arise when a company’s pretax financial (or book) income is greater than its taxable income for a period.

A deferred tax asset may be recognized for revenues or gains that are taxable before they are recognized in financial income. This could occur when one receives advance payment for goods or services to be provided in future years. For tax purposes, the advance payment is included in taxable income upon
the receipt of cash. Yet, for book purposes, the rent revenue is not immediately recognized. As a result, taxable income is greater than book income for the current year. Thus, taxable income will be less than book income in the future when the rent is recognized on the books. When the liability is settled, future tax deductible amounts will result. Overall, deferred tax assets arise when a company’s taxable income is greater than its pretax financial (or book) income for a current period.

e. Explain what a deferred income tax valuation allowance and when it should be recorded.

A deferred income tax valuation allowance represents the portion of a deferred tax asset for which it is more likely than not that a tax benefit will not be realized. “More likely than not” means a level of likelihood of at least slightly more than 50 percent. The valuation allowance is created as a means to reduce the carrying value of the deferred tax asset. The allowance account is evaluated at the end of each accounting period for potential adjustment if the expected realizable value of the deferred tax asset changes. The allowance is a balance sheet account and is only applicable to deferred tax assets. All available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, a valuation allowance for deferred tax assets is needed. Positive evidence supports the conclusion that a valuation allowance is not needed and can include evidence like a strong earnings history exclusive of the loss that created the future deductible amount, along with the fact that the loss is an aberration rather than a continuing condition. Negative evidence supports the conclusion that
a valuation allowance is needed and can include losses expected in early future years or cumulative losses in recent years.

f. **Consider the information disclosed in Note 8 - Income Taxes to answer the following questions:**

i. **Using information in the first table in Note 8, show the journal entry that ZAGG recorded for the income tax provisions in fiscal 2012?** *(in thousands)*

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Tax Expense</td>
<td>9,393</td>
</tr>
<tr>
<td>Deferred Tax Asset (net)</td>
<td>8,293</td>
</tr>
<tr>
<td>Income Taxes Payable</td>
<td>17,686</td>
</tr>
</tbody>
</table>

ii. **Using the information in the third table in Note 8, decompose the amount of “net deferred income taxes” recorded in income tax journal entry part f. i. into its deferred income tax asset and deferred income tax liability components.**

The amount of “net deferred income taxes” recorded when recording income taxes reflects the change in both deferred tax assets and the change in deferred tax liabilities. In 2011, the total of the deferred tax assets was $6,300,000, while at the end of 2012, the total amounted to $14,302,000. This implies the total deferred tax assets increased $8,002,000. Yet, the net deferred income taxes were recorded at $8,293,000. This is because the deferred tax liabilities decreased from $1,068,000 to $794,000. This change is reflected as a decrease in the deferred tax liabilities as a debit of $292,000. Yet, the net effect of the $8,002,000 increase in the deferred tax
assets and the $292,000 decrease in the deferred tax liabilities is reflected as a debit to deferred tax assets (net) for $8,293,000.

iii. The second table in Note 8 provides a reconciliation of income taxes computed using the federal statutory rate (35 percent) to income taxes computed using ZAGG’s effective tax rate. Calculate ZAGG’s 2012 effective tax rate using the information provided in their income statement. What accounts for the difference between the statutory rate and ZAGG’s effective tax rate?

The effective tax rate can be found by dividing total income tax expense by pretax financial income. ZAGG’s total income tax expense for 2012 was $9,393,000, while its total income before the income tax provision is $23,898,000. Therefore, ZAGG’s effective tax rate equals 39.3 percent for 2012. As is noted previously, the effective tax rate can differ from the statutory tax rate due to permanent differences between taxable income and pretax financial income or because of changes in the tax rate during the given period of years.

iv. According to the third table in Note 8 - Income Taxes, ZAGG had a net deferred income tax asset balance of $13,508,000 at December 31, 2012. Explain where this amount appears on ZAGG’s balance sheet.

The net deferred income tax asset balance of $13,508,000 appears in two different places on the balance sheet: $6,912,000 of it appears in the current assets section under “deferred income tax assets.” The other $6,596,000 appears in the non-current section for assets since the amount
will affect future periods that are not within one year of the balance sheet date.
CASE 6: REVENUE RECOGNITION
Apple, Inc.

May 2, 2018
This case analyzed the financial statements and related disclosures of Apple Inc. The multinational technology company headquartered in Cupertino, California is known for its personal computers, mobile devices, portable digital music, and video players. Its products range from the iPhone, to Mac computers, iPads, digital music through its iTunes Stores, Apple Watches, Apple TV subscriptions, and Mac-branded accessories like headphones, watch bands, phone cases, and power cables. Apple sells its products through a myriad of ways, such as in its online stores, its retail stores all around the globe, through its sales force, and through third-party wholesalers and retailers.

Because of the multiple platforms in which Apple’s products are sold, this case offered a unique opportunity to develop a greater understanding of the ways in which companies recognize revenue in relation to their specific policies outlined in financial statements, along with the specific requirements outlined by the Financial Accounting Standards Board through ASC 605 and ASC 606. Overall, the company recognizes revenue either when a sale is made in one of its retail stores or when a product is shipped to a customer, whether that be an individual or a reseller. Apple does retain some deferred revenue, as is noted on its Consolidated Financial Statements, from the sale of gift cards and from AppleCare services and support contracts, along with revenue from embedded unspecified software upgrade rights.
a. In your own words, define “revenues.” Explain how revenues are different from “gains.”

Revenues are inflows or sources of enhancements during a period that result from delivering or producing goods or rendering services. Revenues are the result of an entity’s ongoing major or central operations. On the other hand, gains are increases in equity from peripheral or incidental transactions that do not constitute the entity’s ongoing major or central operations. For example, a gain could result when a piece of equipment is sold in excess of its book value. Revenues are included in the Income Statement in Operating Section, along with cost of goods sold, selling expenses, and administrative or general expenses. Realized gains are included on the Income Statement in the Nonoperating Section under “Other Revenues and Gains.”

b. Describe what it means for a business to “recognize” revenues. What specific accounts and financial statements are affected by the process of revenue recognition? Refer to ASC 606.

An entity may “recognize” the considerations received as revenue from the determined transaction price when a performance obligation is satisfied. A performance obligation is a promise in a contract with a customer to transfer to the customer a distinct good or service or a series of distinct goods or services that are substantially the same. A valid contract exists when the contract has commercial substance, both parties have approved the contract, identification of
the rights of the parties has been established, payment terms are identified, and it is probable that consideration will be collected. The performance obligation is satisfied when the customer obtains control of the good or service. Indicators that the customer has obtained control include the company having the right to payment for the asset, the company having transferred legal title to the asset, the company having transferred physical possession of the asset, the customer having significant risks and rewards of ownership, and the customer having accepted the asset.

A business can satisfy performance obligations either at a point in time or over a period of time. Revenue is recognized over a period of time if the customer receives and consumes the benefits as the seller performs, the customer controls the asset as it is created or enhanced, or the company does not have an alternative use for the asset created or enhanced. Specific accounts related to revenue recognition include Balance Sheets account such as Accounts Receivable and Interest Receivable. When the performance obligation is satisfied, Accounts Receivable (or Cash) is debited, and Revenue is credited. The Revenue account is closed out at the end of each period, but the amount of Revenue or Sales each period appears on the Income Statement, too.

c. Refer to the Revenue Recognition discussion in Note 1. In general, when does Apple recognize revenue? Explain Apple’s four revenue recognition criteria. Do they appear to be aligned with the revenue recognition criteria you described in part b, above?
Apple recognizes revenue when “persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collection is probable.” Apple’s products are considered “delivered” once the items have been shipped and title and risk of loss have been transferred. Apple’s revenue recognition criteria closely reflect the process of revenue recognition, which includes identifying a contract with customers, identifying the separate performance obligations in the contract, determining the transaction price, allocating the transaction price to the separate performance obligations, and recognizing revenue when each performance obligation is satisfied. Collection being “probable” means that the collection is likely to occur.

d. What are multiple-element contracts and why do they pose revenue recognition problems for companies?

Multiple-element contracts are contracts with customers that involve more than one performance obligation, including products, services, or rights to use assets, in which the seller will perform multiple revenue-generating activities. For Apple, these multiple-element contracts often include tangible products that contain software that is essential to the tangible product’s functionality and undelivered software elements. Apple allocates revenue to all deliverables based on their relative selling prices by using a hierarchy: (i) vendor-specific objective evidence of fair-value (“VSOE”), (ii) third-party evidence of selling price (“TPE”), and (iii) best estimate of the selling price (“ESP”). VSOE occurs when Apple sells a deliverable separately, while ESP is a best-estimate of what the selling price would be if the deliverables were sold on a stand-alone basis.
Multiple-element contracts can pose revenue recognition issues because of timing issues of when to recognize the revenue and at what amount to record the revenue for each element within the contract.

Described in detail in Note 1, Apple mentions that it has identified two deliverables when selling devices like iPhones, iPads, Apple TVs, and iPod Touches. One deliverable involves the hardware and software essential to the functionality of the hardware device delivered at the time of the sale. Another deliverable is the embedded right included with the purchase of an iPhone, iPod touch, and Apple TV to receive on a when-and-if-available basis, future unspecified software upgrades and features relating to the product’s essential software. Apple allocates revenue between these two deliverables using the relative selling price method, based on the Company’s ESPs. The revenue allocated to delivered hardware and related software is recognized at the time of sale, while the revenue allocated to embedded unspecified software upgrade rights is deferred and recognized on a straight-line basis over 24-months. Related costs of sales are recognized at the time of sale.

e. **In general, what incentives do managers have to make self-serving revenue recognition choices?**

Overall, when more products are sold, more revenue is generated. Managers often have the option to make self-serving revenue recognition choices. These choices affect how revenue will be classified on financial statements and when revenues will appear on financial statements, along with the expenses related to these revenues. Management’s main goal is usually to maximize profit.
If profit is maximized, managers are likely to receive bonuses or promotions. Therefore, being able to determine the best way to classify and recognize revenues can help increase the likelihood of those bonuses, promotions, and other incentives.

f. Refer to Apple’s revenue recognition footnote. In particular, when does the company recognize revenue for the following types of sales?

i. iTunes songs sold online.

Apple often sells products that are obtained from other companies, such as songs sold through the iTunes Store. For these sales, Apple is not the primary obligor to users of the software related to the iTunes songs. Therefore, third-party developers determine the selling price of the software. Apple accounts for these sales on a net basis by recognizing only the commission it retains from each sale and including that commission in net sales in the Consolidated Statements of Operations.

ii. Mac-branded accessories such as headphones, power adaptors, and backpacks sold in the Apple stores. What if the accessories are sold online?

Apple sells Mac-branded accessories both in stores and online. When these products are sold in Apple stores, revenue is recognized at the time of sale. For online sales to customers, Apple defers revenue until the customer receives the product because Apple legally retains a portion of the risk of loss on these sales during transit.

iii. iPods sold to a third-party reseller in India.
When Apple sells products to third-party resellers, such as selling iPods to a third-party reseller in India, the company recognizes revenue from that sale to the reseller once the product has been shipped and the title and risk of loss have been transferred.

iv. **Revenue from gift cards.**

When Apple sells gift cards, it records deferred revenue upon the sale of the card, which is recognized and earned upon redemption of the card or a portion of the amount of the card by the customers.
In this case, I explored Splunk’s data analytics software tool that organizations use to process big data in real time, while offering insights into opportunities and risks for business entities. While learning more about Splunk’s different functions and features, I gained exposure to the different platforms in which the tool can function, along with the different types of databases, servers, and information systems it has partnered with for compatibility. Overall, Splunk offers functions within three main areas—IT operations, security and compliance, and analytics—while specializing in machine log analysis. Additionally, I researched how different companies within different industries have utilized Splunk to increase productivity, security, profitability, and competitiveness.

With my future career in mind, having technical knowledge of and experience with Splunk would certainly be an asset for me, regardless of whether I am in the tax, audit, or advisory service line. With audit specifically, I would be able to better perform engagements and have a broader and more well-rounded picture of a client’s business. However, with the efficiencies and time reductions resulting from Splunk, I would also have more specific knowledge of a client’s business in order to attest to the accuracy of the entity.
a. **Identify the purpose of this tool and describe, in general, how it is used to make business decisions.**

Splunk, Inc. offers a business intelligence software tool used for machine log analysis and visualization to allow its users to efficiently and effectively utilize big data in an organized way. Splunk’s product can operate on-premises, in the cloud, or via a hybrid approach. Through all three platforms, Splunk helps users solve IT, security, and business challenges, as the platform has artificial intelligence integrated within itself to detect anomalies, aid in prediction, and find meaning in voluminous and diverse data.

Splunk identifies five main areas in which its tool helps generate solutions: infrastructure and IT operations, application delivery, security and compliance, business analytics, and IoT (Internet of Things) and industrial data. In regards to infrastructure and IT operations, Splunk can help to prevent downtime for critical IT services and allows for real-time monitoring and proactive alerting. Splunk offers a versatile function, specifically with application delivery, as the platform can partner with over 1,300 applications for tracking application performance, user activity, and transactions. In addition to monitoring IT operations, Splunk allows for real-time security monitoring and historical analysis to detect, prevent, and stop anomalies and security threats. Through its business analytics function, Splunk offers insights into business processes, customer behavior, internet clickstream data, and revenue streams. One of the most impressive features of
Splunk is its IoT and industrial data ability to supervise and analyze machine log data from multiple devices, sensors, and control systems. For example, a *Wall Street Journal* article noted that when Macy’s experienced online site growth and its number of servers increased from five to sixty, the department store incorporated Splunk into its information system and servers. With Splunk, Macy’s was able to monitor all 60 servers, while also saving time during monitoring compared to when it had only 5 servers that were monitored manually. Now, Splunk scans all 60 servers for patterns of errors and provides real-time reporting and updates.

With the use of Splunk’s main functions, users can make better cost-effective decisions within their IT, business, and security operations. With real-time monitoring of IT operations, Splunk users are able to predict service-level degradation of IT before it occurs and make proper decisions in the event. As Splunk is incorporated into daily business operations, users will be able to track different forms of revenue to decide where to expand or stop sales and identify where customers are being lost to competition. Additionally, the security function can permit and restrict access to sensitive information for certain users, along with putting the proper security measures in place to prevent and stop security attacks on the business.
b. How, specifically, would you use the tool in the following business settings?

Create at least three specific scenarios for each category in which the tool would lead to more efficiency and/or better effectiveness. Be sure to describe what kind of data your tool would use for each scenario.

i. Audit

Splunk’s platform allows for strategic auditing when an engagement team is auditing a client. One of the specific features of the platform is the ability to automate reporting to demonstrate compliance. When a firm audits a client, the auditors can upload specific rules and regulations per the Sarbanes-Oxley Act, along with control frameworks, for public companies to test for compliance. In attempt to make testing for compliance more efficient, Splunk can be utilized for search for audit trails from a client’s servers on a daily basis. Auditors can make audit trail collection and reporting more efficient by filtering and labeling innocuous activity as “ok” to minimize future review and understand patterns. This allows for more time to be focused on outlier analysis of the anomalies labeled as “not ok,” while also doing so in real-time.

With strategic auditing in mind, Splunk can also aid users when evaluating a client’s internal controls. Specifically, the tool offers integrity monitoring. This means that both server and internet clickstream data can be monitored and reviewed to ensure employees are working responsibly. Additionally, Splunk can collect and monitor access data. This can verify when and for how long employees are working, along with which
employees are using key cards to gain physically access to company property and where. With real-time integrity monitoring, review of changes and updates to company documents can be made, as well, when checking internal controls.

Finally, Splunk can aid in strategic auditing of a client’s information security management to minimize risk, fines, and liability. For example, if a firm’s client was a healthcare services organization, one of the client’s main priorities would be IT security, especially in regards to patient data. To ensure data security, Splunk tracks firewall activity to ensure a user’s firewall policy is in place and functioning correctly. Security threats and changes to security can be tracked over time. Auditors can review and monitor the firewall activity when evaluating a client’s internal controls. This is especially critical for minimizing fines and liability in regards to data breaches, as being noncompliant with security program requirements and breach notification rules can both amount to fines of up to $5 million each. Therefore, Splunk can enhance a client’s information security by allowing auditors to detect security attacks and prevent future attacks.

ii. Tax Planning

In addition to aiding in audit, Splunk can be capitalized on as a tool in the profession of tax services. Specifically, when providing services for a multinational company, a user can incorporate every tax code from every country for tax planning. By being able to create specifications and filters
within a company’s information system to view different impacts on revenue, a user can optimize tax structures when considering what would be the bottom-line “taxable income” for a multinational client. By providing real-time updates to tax codes from around the world, clients can see the impact of these tax developments on cross-border transactions.

Splunk’s tool also offers the opportunity for users with clients who are considering business expansion, specifically with mergers and acquisitions in mind. A tax professional would be able to aid in tax planning for its clients by identifying which different tax rates and laws would apply depending on location and the entity that the client is going to merge with or acquire. Additionally, tax risks, inefficiencies and compliance issues can be identified, which will allow for future implementation of a better tax compliance and internal control system after a merger or acquisition.

Finally, tax professionals can utilize Splunk for point-of-sale data in real-time. Point-of-sale data range from sales tax data and the status of store financials, to tracking revenue streams and product inventory to identify seasonal trends and areas for growth, along with areas that are lacking for its clients. This would allow for tax professionals and its clients to have real-time knowledge of what taxable income would be at any point during the course of business when incorporating tax codes with the platform. Users would be able to see how taxable income and tax obligations change throughout the quarter or fiscal year. Splunk will be
especially useful when considering updates to tax codes and how those will affect businesses in the future. With the real-time feature of the tool, users and their clients can better practice effective tax governance and compliance.

c. Write to your future public accounting partner explaining why your team should invest in the acquisition of and training in this tool. Explain how the tool will impact the staffing and scope of your future.

Splunk’s business and analytics software offers a plethora of opportunities for insights into clients’ data from a professional services standpoint. Splunk would not only offer real-time analysis and monitoring of a firm’s client’s data, but would also allow more time for professionals to focus on anomalies, risks and threats, and opportunities for growth within the areas of IT operations, security and compliance, and business analytics. More importantly, utilizing Splunk will aid in the ease of audit and tax services. By investing in this tool, public accountants would expand their audit capabilities by being able to analyze and review compliance for a client, aid in information security management, and offering a better evaluation and analysis of a client’s internal control environment. Instead of performing just an audit sample, all machine log data would be tested and analyzed due to Splunk’s data processing capabilities. Moreover, the platform would expand tax services for a firm. Splunk’s platform can be tailored to multistate or multinational clients for strategic planning with different tax laws that are subject to constant changes and updates. Additionally, Splunk allows for
tax optimization structures to be created with clients considering expansion, along with mergers and acquisitions.

Although investing in Splunk would result in acquisition, training, and maintenance costs, the benefits of time and cost savings, along with offering more efficient and improved services, outweigh the costs. Splunk’s website offers a multitude of free online resources to assist in training, too. Also, there are infographics, product briefs, and solution guides available for customers, along with videos and webinars in which customers can enroll. Investment in this tool would require for future staffers to be trained and experienced in Splunk, but would equip employees with better technical and analytical skills. Overall, Splunk will help professionals to answer more questions at a deeper level, create new areas and questions for further exploration, and bring more value to the services provided to clients.
This case examined the financial statements for the international franchiser of chocolate candies, Rocky Mountain Chocolate Factory, Inc. This case required me to prepare my own set of financial statements after preparing a simple general ledger in the form of an excel spreadsheet for the company. Additionally, through this case, I was able to properly classify the different operating, investing, and financing activities of Rocky Mountain Chocolate Factory based on the journal entries I made. Through the completion of the ledger spreadsheet, I was able to visualize and understand a company’s full accounting cycle when preparing financial statements and related entries. Overall, I think my completion of this case greatly enhanced not only my understanding of basic accounting principles and the accounting cycle with its relation to financial statement preparation, but it also greatly enhanced my technical skills involving Excel. By using Excel shortcuts and cell references, I was able to minimize time spent doing manual entries of account titles and numbers. This allowed for greater analysis of the financial position of the company, and I believe these skills are something I will greatly benefit from in my future career as an accountant.
APPENDIX: Questions for Case Study 8

a. Prior to examining the company’s actual balance sheet, read the description of Rocky Mountain Chocolate Factory, above. What accounts do you expect to see on the balance sheet? Which accounts constitute the major assets? Which accounts constitute the major liabilities?

With Rocky Mountain Chocolate Factory, Inc. being a confectionery manufacturer and retail operator, I would expect to see inventory as a major asset on its balance sheet. In terms of other assets, Rocky Mountain Chocolate Factory would likely have cash and cash equivalents, accounts receivable, and property and equipment. On the other hand, major liabilities would probably include accounts payable, salaries and wages to employees, and other accrued expenses.

b. Based on the transactions recorded, list at least three adjustments or reclassifications that might need to be made prior to preparing the final financial statements.

Rocky Mountain Chocolate Factory would likely have to make adjustments to its inventory account before preparing the final financial statements to reconcile the account to its physical count at year-end. Another entry that may need to be made would involve the reconciliation of accrued salaries and wages, along with other accrued expenses, as some of these accrued expenses may have been partially paid for throughout the year. The same could also be said for its accounts payable and accounts receivable accounts. Finally, Rocky Mountain Chocolate Factory
might need to account for the depreciation associated with its existing and new property and equipment.
### Table 1: General Ledger

<table>
<thead>
<tr>
<th></th>
<th>General Ledger</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Inventories</td>
</tr>
<tr>
<td></td>
<td>Accounts Payable</td>
</tr>
<tr>
<td>2</td>
<td>Inventories</td>
</tr>
<tr>
<td></td>
<td>Accrued Salaries &amp; Wages</td>
</tr>
<tr>
<td>3</td>
<td>Cash</td>
</tr>
<tr>
<td></td>
<td>Accounts Receivable</td>
</tr>
<tr>
<td></td>
<td>Sales</td>
</tr>
<tr>
<td></td>
<td>Cost of Sales</td>
</tr>
<tr>
<td></td>
<td>Inventories</td>
</tr>
<tr>
<td>4</td>
<td>Accounts Payable</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
</tr>
<tr>
<td>5</td>
<td>Cash</td>
</tr>
<tr>
<td></td>
<td>Accounts Receivable</td>
</tr>
<tr>
<td>6</td>
<td>Sales &amp; Marketing</td>
</tr>
<tr>
<td></td>
<td>General &amp; Administrative</td>
</tr>
<tr>
<td></td>
<td>Retail Operating</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
</tr>
<tr>
<td></td>
<td>Other Accrued Expenses</td>
</tr>
<tr>
<td>7</td>
<td>Accrued Salaries &amp; Wages</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
</tr>
<tr>
<td>8</td>
<td>Cash</td>
</tr>
<tr>
<td></td>
<td>Deferred Income</td>
</tr>
<tr>
<td>9</td>
<td>Property &amp; Equipment</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
</tr>
<tr>
<td>10</td>
<td>Retained Earnings</td>
</tr>
<tr>
<td></td>
<td>Dividends Payable</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
</tr>
<tr>
<td>12</td>
<td>Cost of Sales</td>
</tr>
<tr>
<td></td>
<td>Inventories</td>
</tr>
<tr>
<td>13</td>
<td>Depreciation &amp; Amortization</td>
</tr>
<tr>
<td></td>
<td>Property &amp; Equipment</td>
</tr>
<tr>
<td>14</td>
<td>General &amp; Administrative</td>
</tr>
<tr>
<td></td>
<td>Retail Operating</td>
</tr>
<tr>
<td></td>
<td>Accrued Salaries &amp; Wages</td>
</tr>
</tbody>
</table>
## Table 2: Income Statement

<table>
<thead>
<tr>
<th>Rocky Mountain Chocolate Factory, Inc.</th>
<th>Income Statement</th>
<th>For Year Ended February 28, 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>$ 22,944,017</td>
<td></td>
</tr>
<tr>
<td>Franchise &amp; Royalty Fees</td>
<td>5,492,531</td>
<td></td>
</tr>
<tr>
<td><strong>Total Revenues</strong></td>
<td><strong>28,436,548</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Costs &amp; Expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of Sales</td>
<td>14,910,622</td>
<td></td>
</tr>
<tr>
<td>Franchise Costs</td>
<td>1,499,477</td>
<td></td>
</tr>
<tr>
<td>Sales &amp; Marketing</td>
<td>1,505,431</td>
<td></td>
</tr>
<tr>
<td>General &amp; Administrative</td>
<td>2,422,147</td>
<td></td>
</tr>
<tr>
<td>Retail Operating</td>
<td>1,756,956</td>
<td></td>
</tr>
<tr>
<td>Depreciation &amp; Amortization</td>
<td>698,580</td>
<td></td>
</tr>
<tr>
<td><strong>Total Costs &amp; Expenses</strong></td>
<td><strong>22,793,213</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Operating Income</strong></td>
<td></td>
<td><strong>5,643,335</strong></td>
</tr>
<tr>
<td><strong>Other Income (Expense)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest Income</td>
<td>27,210</td>
<td></td>
</tr>
<tr>
<td>Other, net</td>
<td>27,210</td>
<td></td>
</tr>
<tr>
<td><strong>Income Before Income Taxes</strong></td>
<td></td>
<td><strong>5,670,545</strong></td>
</tr>
<tr>
<td><strong>Income Tax Expense</strong></td>
<td></td>
<td><strong>2,090,468</strong></td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td></td>
<td><strong>$ 3,580,077</strong></td>
</tr>
<tr>
<td><strong>Basic Earnings per Common Share</strong></td>
<td></td>
<td><strong>$ 0.60</strong></td>
</tr>
<tr>
<td>Weighted Average Common Shares Outstanding</td>
<td></td>
<td><strong>6,012,717</strong></td>
</tr>
</tbody>
</table>
Table 3: Balance Sheet

<table>
<thead>
<tr>
<th>Rocky Mountain Chocolate Factory, Inc.</th>
<th>Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>As of February 28, 2010</strong></td>
<td></td>
</tr>
</tbody>
</table>

### Assets

#### Current Assets
- **Cash & 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 & Equipment, Net
- **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 Long-Term Assets
- **Total Long-Term Assets**: $6,695,378

#### Total Assets
- **Total Assets**: $18,919,914

### Liabilities & Stockholders' Equity

#### Current Liabilities
- **Accounts Payable**: $877,832
- **Accrued Salaries & 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
- **Deferred Income Taxes**: 894,429

#### 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 & Stockholders' Equity
- **Total Liabilities & Stockholders' Equity**: $18,919,914
Table 4: Cash Flows

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Purchase inventory</td>
<td>Operating Activity</td>
</tr>
<tr>
<td>2. Incur factory wage</td>
<td>Operating Activity</td>
</tr>
<tr>
<td>3. Sell inventory for cash &amp; on account</td>
<td>Operating Activity</td>
</tr>
<tr>
<td>4. Pay for inventory</td>
<td>Operating Activity</td>
</tr>
<tr>
<td>5. Collect receivables</td>
<td>Operating Activity</td>
</tr>
<tr>
<td>6. Incur SG&amp;A (cash &amp; payable)</td>
<td>Operating Activity</td>
</tr>
<tr>
<td>7. Pay wages</td>
<td>Operating Activity</td>
</tr>
<tr>
<td>8. Receive franchise fee</td>
<td>Operating Activity</td>
</tr>
<tr>
<td>9. Purchase PPE</td>
<td>Investing Activity</td>
</tr>
<tr>
<td>10. Dividends declared &amp; paid</td>
<td>Financing Activity</td>
</tr>
</tbody>
</table>
In this case, our class explored three separate scenarios of Patterson Accountancy students who were planning on completing an internship with a firm. For each scenario, we were asked to decide whether we did or did sympathize with the student and why we did or did not sympathize with the student or students in the scenario. This case is relevant to my future career, as I have already accepted an offer with an accounting firm. The different scenarios and my reasons for sympathizing or not with the students in the scenario required me to examine my own choices regarding the internship I will complete in the spring and analyze whether I had been transparent and honest with the firms throughout the recruiting process.
The first scenario involved a student named Eric who was planning on completing an internship in tax, but did not plan on returning to work for the firm of his internship after completing his Master’s degree. Instead, he was interested in attending law school and hopefully becoming a tax lawyer one day, as his cousin had apparently been a successful tax lawyer in Manhattan. Thus, for him, the internship only served as a resume booster to help him get accepted to a top law school.

In some ways, I sympathized with Eric, as I have had serious thoughts about attending law school while completing the Master’s program. The possibility of me returning to a firm after graduating from law school, though, is still more likely. The problem with this scenario, though, is that Eric does not plan to be transparent with firms throughout the recruiting process. Yet, if he was transparent, he would be unlikely to get any offer. I do think his decision to not be transparent with the firms while knowing he is not going to return to a firm full-time after graduating is wrong, as the firms have invested a significant amount of resources into recruiting and training Eric for the internship. Additionally, the internship he is accepting is one that a student who is actually serious about a career in public accounting could have taken and may not have been given an offer. However, if he were not sure whether he wanted to pursue a career in tax law or in tax accounting, he should still voice those doubts to the firms during recruiting with an attitude of working in public accounting for at least a few years. The internship is roughly eight weeks, which is not much time to figure out whether this career is actually something one would be happy with for a few years. Therefore, if the
student is going to complete the internship, he should at least work in the field for a minimum of a year or two.

The second scenario involved two students, both of whom were also planning on completing internships through the Patterson School of Accountancy. However, one of the students, Olivia, wants to obtain a Masters of Business Administration and then focus on a career in consulting while traveling the world. The other student, Jamie, was interested in a career in investment banking after working for a firm for a few years.

For this scenario, I sympathized with the students, as both of them were more open to returning to the firm of their internship for some time rather than immediately pursuing a different career. However, I do think that both students should have been more transparent with the firms that they were interested in certain industries that could prepare them for future careers outside of public accounting. Jamie noted that he would work in public accounting for a few years, which I do think is important as a courtesy for all of the investments and efforts the firms have made in recruiting and training interns. Therefore, Jamie should work for at least 2.5-3 years with the firm that he completed his internship with. This scenario highlighted the fact that it is okay to want to pursue other careers outside of public accounting, but that it is just as important to give a return to a firm before leaving for a different career.

The third scenario involved an email thread between Dr. Dickinson and a former student who was reaching near the end of his Master’s program. He had already completed an internship in Washington, D.C., but did not enjoy living in D.C. as much as he thought he would. He reached out to Dr. Dickinson asking for advice on how to talk to
the firm he had been given a full-time offer to work for in D.C., but wanted to know if it would be possible to transfer his offer from D.C. to Dallas, Texas.

In this scenario, I sympathized somewhat with the student. However, I did have major issues with the way that the student went about the issue he was trying to solve. Since the student knew that he did not want to go back to D.C. once he completed the internship, he should have contacted the firm’s recruiter immediately following the internship to discuss potentially transferring to a different office. Again, in this scenario, the student was not honest and transparent after the internship, although it was never the student’s plan to intern in one location and then hopefully transfer to another. The problem is that he did not take his decision as serious as he could have. Students should really evaluate where they want to be and if that location is somewhere they can see themselves living in the long-term.

Firms do recognize that students may not end up liking the location of where they initially intern at, and depending on the timing, office location, and circumstances of the intern, firms might be able to transfer offers. However, communicating with firms as soon as you know that you wish to transfer to a different office is of the utmost importance. While I was going through the recruiting process, I had doubts of whether my first location preference, Washington, D.C., was the right choice. Before recruiting, I had been told my professors to pick a location and be strong and convincing with your choice. However, after going through the interview process, I had serious doubts. I reached out to the recruiter within a few days of the interview and was honest with her about my doubts, and that in the end, I would most likely end up wanting to transfer to an office closer to home. The recruiter was happy to make that transition for me, and I felt a
lot better about accepting an offer from that firm in the future because of the transparency and honesty between both parties.
This case examined the financial statements for Generic Bank, along with its report pertaining to available-for-sale security details by asset class. Additionally, much examination of current accounting standards and rules was requirement for determining debt security impairment in the event of sales. Professional judgment from the role of Generic Bank, a bank regulator, and an external auditor was required to complete the case, which resulted in a greater understanding of how different incentives can influences professional judgment within the financial reporting field. Overall, I believe my efforts put forth within this case have improved my professional judgment and discretion-related skills, which will be of the utmost importance in my future career as an external auditor for a public accounting firm. Additionally, understanding the extent of applicable impairment losses will allow for me to better determine the accuracy of management’s assertions in financial statements and allow me to decide whether the financials are free of material misstatement related to both impairments of and the sale of debt securities, particularly available-for-sale securities.
a. Assume that Generic Bank does sell the aforementioned securities shortly after year end in early 20x3. Does Generic Bank have an impairment loss on the seven securities designated above in 20x2?

According to ASC 326-30-25-1, an investment is impaired if the fair value of the investment is less than its amortized cost basis. Additionally, according to 326-20-35-2, an entity shall determine whether a decline in fair value below an amortized cost basis has resulted from a credit loss or other factors. If the decline in fair value is related to credit losses, the impairment should be recorded through an allowance for credit losses, but is limited by the amount that the fair value is less than the amortized cost basis. Since no allowance for credit losses has been established for Generic Bank, any impairment would be realized and recorded through other comprehensive income if a sale of the impaired securities were to take place.

The seven securities that Generic Bank is considering to sell have a total amortized cost of $386,044,000, while their total fair value is $331,835,000, which is the amount at which Generic Bank would sell the securities. However, the sale would result in a loss of $54,209,000, which would affect earnings. Since the securities would be sold, there would be a realized impairment loss of the available-for-sale debt securities, despite the fact that the bank concluded no credit losses exist because although the bank asserts it has the ability to hold these securities until they mature or the unrealized losses recover,Generic Bank does
not have the intent to hold these securities until then, as they sell them before either of occur.

b. Assume that generic Bank does sell the aforementioned securities shortly after year end in early 20x3. Does Generic Bank have an impairment loss on securities other than the seven securities sold? If so, how would you determine the extent of the impairment?

As Generic Bank notes, roughly 60 percent of its unrealized losses related to securities have been in an unrealized loss position for longer than one year. After the sale of the 7 securities, Generic Bank would have 48 securities in an unrealized loss position. Although Generic Bank has the ability to hold these securities until maturity, along with the fact that these investments are impaired solely due to interest rates, there is still consideration of impairment losses on these securities. Before the sale of the seven securities, Generic Bank had $1,173,091 in total gross unrealized losses. However, if the seven securities are sold, $54,209 of the gross unrealized losses are realized. Thus, after the sale of the seven securities, gross unrealized losses would total $1,118,882.

According to ASC 326-20-25-6, in assessing whether a credit loss exists, an entity shall compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. If the present value is less than the amortized cost basis, a credit loss exists and an allowance for credit losses should be recorded for the credit loss, but is limited by the amount that the fair value is less than amortized cost basis. The estimates of expected future cash flows shall be the entity’s best estimate based on past events, current
conditions, and on reasonable and supportable forecasts. However, as ASC 326-30-35-4 notes, impairment shall be assessed at the individual security level. Additionally, General Bank should reassess any credit losses each reporting period when there is an allowance for credit losses.

Generic Bank notes that 60 percent of the unrealized losses related to securities have been in an unrealized loss position for longer than one year. ASC 326-30-55-1 notes, however, that the length of time a security has been in an unrealized loss position should not be a factor, by itself or in combination with others, that an entity would use to conclude that a credit loss does not exist. In determining whether a credit loss exists, numerous factors should be considered, such as the extent to which fair value is less than amortized cost basis, along with adverse conditions specifically related to the security and any changes to the rating of the security by a rating agency. In general, the extent of the impairment would be the difference between the amortized cost and fair value of the securities. Thus, after the sale of the seven aforementioned securities, gross unrealized losses, for both securities that have been in continuous unrealized loss positions for greater than and less than 12 months, would total $1,118,882. This could be the amount for which the credit allowance would be established, but as the credit allowance account is a more subjective type of account, this decision involves more professional judgment and may vary by the one who establishes the allowance.

As ASC 326-30-35-10 notes, if an entity intends to sell debt securities, or it is more likely than not that the entity will be required to sell the security before
recovery of its amortized cost basis, any allowance for credit losses shall be written off and the amortized cost basis should be written down the security’s fair value. However, if the entity does not intend to sell the debt security, Generic Bank should consider available evidence to assess whether it is more likely than not that it will be required to sell the security before recovery of amortized cost basis. Therefore, Generic Bank must consider whether or not it has the intent to sell any of the remaining 48 available-for-sale debt securities, or whether it is more likely than not that it will have to sell them before recovery to determine whether an impairment exists for the remaining securities.

According to the FDIC’s policy regarding securities and derivatives, treatment of declines in fair value may vary. Different examiners can assign more of less severe quality classifications for individual debt securities, with substandard quality being the least severe classification, followed by doubtful quality, with the most severity classification resulting in a loss. Loss classifications are assigned to assets that are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. Generic Bank should have a credit risk management framework to analyze its securities holdings for examiners to utilize when assessing the available-for-sale debt securities. The credit analysis should vary based on structural complexity of the security, the type of collateral and external ratings. FDIC’s policy agrees with U.S. GAAP, as when the subpar quality of an available-for-sale debt security is deemed to be other than temporary, the security is classified with a loss, and the security’s fair value becomes the new cost basis, as it continues to be “marked-to-
market” with the unrealized holding gains (losses) reported directly in equity capital.

c. Does your answer change if you assume the role of Heather Herring, the external auditor? Does your answer change if you assume the role of a bank regulator? What other factors might an external auditor or regulator consider in making their determination?

Assuming the role of Heather Herring, the external auditor, an impairment loss would exist and need to be recorded for the financial statements for the year ended 20x3. Additionally, an allowance would need to be established, as the $54,209,000 realized loss from the sale of the securities is material for the bank. The external auditor has a responsibility to obtain reasonable assurance that the financial statements are free of material misstatement, whether due to error or fraud. By not recognizing an impairment loss for the $54,209,000, a material misstatement would exist. Similarly, a bank regulator might find recognition of the material loss necessary. Both the auditor and bank regulator would base their decisions off of available information, not just presented by the auditor’s client, but from all available information, included existing environmental factors like existing industry, geographical, economic, and political factors relevant to the debt security (ASC 326-30-35-9).

In addition to available external information, the external auditor would consider the extent to which users of Generic Bank’s financial statements would be influenced by the omission or misstatement of the information relating to the securities’ impairments, while the bank regulator might take into account the
impact of including or not including the impairment losses on the market and how this would affect interest rates. Under ASC 942-320-55-1, regulators of financial institutions can, under appropriate circumstances, conclude that the continued ownership of any asset represents an undue safety & soundness risk to that institution and require the divestiture of that investment.

d. **How would your assessment of the existence of an impairment in both Requirements a and b change if the securities sold had been collectively in a net gain position? What if all of the securities sold were in gain positions?**

As noted previously, impairment should be assessed at the individual security level, meaning the level and method of aggregation used by Generic Bank to measure realized and unrealized gains and losses on its debt securities. Generic Bank denotes five different security types by asset class that it groups into available-for-sale securities. The different security types consist of State and Political Subdivisions, U.S. Treasury Securities, U.S. Government Agency Obligations, Mortgage-backed Securities, and “Other Securities,” which is composed of different corporate bonds. Thus, impairment for each of the five security levels must be assessed separately.

If the securities were sold in a net gain position, impairment losses would need to be assessed on the seven securities sold based on their security level and type because this would still imply that Generic Bank did not have the intent to hold until maturity the securities that were in an unrealized loss position. However, if all securities were sold in a gain position, meaning all seven securities’ fair values were greater than their individual amortized cost basis, then
an impairment loss would not exist for the seven securities sold. Whether there would be an impairment on the remaining 48 securities if the 7 mentioned securities were sold in a net gain position is a matter of professional judgment, as the sale would still impact the credibility of the intent-and-ability-to-hold designation of other securities, but to a lesser extent than if the securities had all been sold in loss positions or in a net loss position. Since the securities would have been sold in a net gain position, this might affect Generic Bank’s ability to hold the remaining securities negatively, especially if the securities sold were all in gain positions, as this would have counterbalanced the gross unrealized losses. Therefore, Generic Bank’s financial portfolio position might worsen if the seven securities sold were all in gain positions.

e. Assume that Generic Bank does sell the aforementioned securities shortly after year end in early 20x3, but that it is adequately capitalized rather than well capitalized, and access to other forms of borrowing to meet liquidity needs has become more limited. Does Generic Bank have an impairment loss on securities other than the seven securities sold?

Under today’s guidance for available-for-sale debt security impairments, companies can use quantitative or qualitative analysis to assess whether a credit loss exists. As previously stated, after the sale of the seven securities, gross unrealized losses will total $1,118,882 for Generic Bank. Now, though, Generic Bank is adequately capitalized, rather than well capitalized, and access to other forms of borrowing to meet liquidity needs has become more limited. The FDIC defines liquidity risk as the possibility that an instrument cannot be obtained,
closed out, or sold at (or very close to) its economic value. With access to other forms of borrowing has become more limited, the sale of the seven securities has increased Generic’s Bank liquidity risk, as it has less securities that could help meet liquidity needs. This qualitative evidence should be taken into account when determining the extent of an impairment loss on securities other than the seven securities sold. Furthermore, the extent of the impairment would be even greater than what it would have been if Generic Bank was deemed “well capitalized.”
In this case, I researched two different cities that I am considering as the location in which I would want to start my career in upon graduation. The two cities that I am considering are Atlanta, GA and Houston, TX. Through comparison and contrast, I was able to learn more about these cities, including information concerning transportation, potential places to live, safe neighborhoods, recreational activities, and even learning where would be most convenient to do my grocery shopping and dry cleaning. Overall, I found this case to be quite beneficial, as Patterson School of Accountancy students interested in completing an internship with a public accounting firm are asked to give location preferences for those internships. The decision of one’s location preference is quite important, as that location is where firms expect the student to start full-time after graduation if an offer is extended to the student after the completion of the internship. Therefore, critically examining one’s choices of where to start one’s career is quite important, especially considering the amount of time and resources that the firms invest in recruiting students. Learning more about similarities and differences in the cities that I have considered for my career will not only help me in deciding the location of the internship that I wish to complete, but also allow me to have reasons for my decision, which can be helpful when asked to explain why I have chosen the city that I wish to start my career.
APPENDIX: Questions for Case Study 11

a. **What is the population?**

In 2017, Atlanta’s population was roughly 486,000, with its metropolitan area being home to 5.9 million people as the fifth-largest metropolitan area in the nation. Houston, on the other hand, had roughly 2.3 million people within the city, with its metropolitan area having an estimated population of 6.8 million as the fifth largest metropolitan area within the United States.

b. **Describe the climate and seasonal fluctuations.**

Atlanta’s climate has been described as humid subtropical, with long, humid summers, with July being its hottest month. Its winters are short and experience more rainfall, with temperatures averaging at roughly 45°F in January, its coldest month. Houston’s climate has been classified as humid subtropical, with August being its warmest month. Its normal annual precipitation is roughly 50 inches, which is the roughly the same average in Atlanta. However, given the terrain of Houston, it is more likely to experience flooding and tropical weather that more likely leads to hurricanes. Houston experiences more humidity year-round, with mild winters compared to the rest of the United States.

c. **Describe the city’s topography, scenery, and other geographic or geological features of the area in which the city is located.**

Atlanta is roughly 1,050 feet above the average sea level and has one of the highest elevations among major cities east of the Mississippi River. Seated near the foothills of the Appalachian Mountains, Atlanta is also atop a ridge south of
the Chattahoochee River. Atlanta has three major high-rise districts, Downtown, Midtown, and Buckhead in the northern part of the city, which are surrounded by leafy neighborhoods. Houston is situated just north of the Texas Gulf Coast with its terrain being classified as “gulf coastal plain.” Like previous stated, the city’s topography is very flat, making flooding a recurring problem for its residents. There are four major bayous that pass through the city, one of which passes through the sole high-rise center in downtown.

d. What are the individual tax rates within the city (e.g., consider federal, state and local income tax, property tax, and any other taxes likely to pay)? Quantify what this means based on a starting salary of $50,000/year)?

Under the Tax Cuts and Jobs Act, federal income tax for 2018 would total $8,195 for an individual with a salary of $50,000. Georgia assesses a 6.00 percent marginal state income tax rate for salaries above $7,000. State income taxes for Georgia would equate to $2,510 for an individual with a $50,000 annual salary. Although Atlanta does not have a local income tax, the state does have a property tax, but property taxes are relatively low compared to the national average. With an assessed home value of $150,000, property taxes for Atlanta would equate to $1,716 annually. Texas does not have any state income tax, but its property taxes are higher compared to the national average. With an assessed home value of $150,000, annual property taxes for an individual would equate to roughly $3,390. Houston’s city sales tax is 8.25 percent, while Atlanta’s city sales tax is 8.9 percent. Total estimated taxes for federal, state and local taxes would equate
to roughly $12,420 in Atlanta, while this amount would be $11,585 in Houston, not taking into account the sales tax difference.

e. **What transportation hubs are in the city?**

The Atlanta metropolitan area has a complex transportation infrastructure and is considered a primary transportation hub of the southeast. Most noting, the Hartsfield-Jackson Atlanta International Airport has been the busiest airport in the world for nearly two decades, with roughly 104 million passengers in 2017, while being Delta Airlines’ major hub. Atlanta offers nearly 100 bus transit routes, which is a part of MARTA—Metropolitan Atlanta Rapid Transit Authority. MARTA consists of a bus, rail, and streetcar system. The rapid rail system spans over 48 miles, with four major lines. The streetcar system serves the downtown area. The “heart” of Atlanta has often been described as the area within the perimeter of Interstate 285, an interstate highway loop that encircles the city for 64 miles and connects three major interstate highways to Atlanta. Houston’s freeway system includes 575.5 miles of freeways and expressways within the 10-country metro area. However, a majority of these expressways are toll roads that require annual expenditures for travel. Houston’s mass transit system—Metropolitan Transit Authority of Harris County, or METRO—consists of buses, trolleys, lift vans, and a 13-mile light rail service that runs from downtown to areas north and south. Just like Atlanta, the METRO system offers a park-and-ride bus system for those residing in the suburbs. Houston has two commercial airports—George Bush Intercontinental and William P. Hobby Airport. Bush Intercontinental is the 16th-busiest airport in the world, while being the second
largest hub for United Airlines. Although not the busiest airport in the world, Bush Intercontinental does rank second behind Atlanta for non-stop domestic and international service in the United States.

f. **What are the city’s most prevalent industries?**

As Atlanta ranks fifth as the headquarters of Fortune 500 companies within the United States, there are several major national and international companies in the metropolitan area. There are seven Fortune 100 companies in Atlanta: Coca-Cola, Home Depot, UPS, Delta, AT&T Mobility, and Newell Rubbermaid. Additionally, major companies like Chick-fil-A, Equifax, SunTrust Banks, and Georgia-Pacific are also headquartered in Atlanta. Dominant industry sectors include trade, transportation, and utilities, along with professional services, financial services, and manufacturing. In contrast to Atlanta, Houston’s economy is primarily based on the energy industry, specifically oil and gas. However, other large sectors include health care, biomedical research, and aerospace. Houston’s metropolitan area is home to 23 Fortune 500 companies. Manufacturing is mainly focused on energy, petrochemicals, and aerospace.

g. **Describe the quality of the city’s healthcare.**

According to a U.S. News report, Texas ranks #38 for overall healthcare, while Georgia lags as #42. The quality of health and medical care received in Atlanta is above average, however, hospitals and medical centers within Houston have had better rankings than hospitals and medical centers in Atlanta.
h. What types of crime are common within the city and where are the locations within the city to avoid?

In Atlanta, the most common violent crimes are aggravated assault and robbery, with larceny being the most common property crime. The areas where crime is most populous include areas within Downtown, East Atlanta, Washington Park and Bankhead. The safest neighborhoods within the city are Buckhead, Poncey-Highlands, and Midtown. Within Houston, there are fewer murders and other violent crimes per capita, but there is also more drug trafficking within Houston due to its size and proximity to major illegal drug exporting countries. The safest areas in Houston are River Oaks, Uptown, and Montrose. Some of the more dangerous neighborhoods are the Third Ward, particular near Dowling and McGregor Streets, and Sunnyside.

i. Based on where you see yourself living for the first three years, how much rent do you expect to pay? Back up this assertion with sample properties from each location. Describe square footage, amenities, need for a roommate, availability of parking, etc.

In Atlanta, I would expect to have two roommates at an apartment in Buckhead. Skyhouse Buckhead offers three bedroom apartments that are roughly 1,400 square feet and cost roughly $1200 per month per tenant. However, the complex offers a parking garage, a gym, direct access to MARTA, a pool, and a gated, safe place to live. I would expect to pay about $42,000 within the first three years on rent. If I were to live in Houston, I would live with my sister at her two-bedroom apartment in Montrose. My rent would be roughly $1,000 for a 1,450 square foot
apartment. The complex in Houston offers a pool, assigning parking in a parking garage, a gated and secure complex, and a fitness center, too.

Atlanta: SkyHouse Buckhead Floor Plan

![SkyHouse Buckhead Floor Plan](image1)

Houston: AMLI City Vista Floor Plan

![AMLI City Vista Floor Plan](image2)

j. What is the typical mode of commuting? Based on your answers identified in the prior question, what are your likely commute times?

Skyhouse Buckhead offers direct access to MARTA. Depending on my assignments within audit, I would either take MARTA or drive myself to client
sites. As one of KPMG’s clients in Atlanta is Home Depot, if I were to be assigned to that client, my typical commute would be roughly 30 to 45 minutes. If I were needed at the office, the typical morning commute would be roughly 30 minutes, or I could take MARTA’s red line, which would be about a 20-minute commute. If I were live in Houston at AMLI City Vista in Montrose, my commute to the KPMG office would roughly 15 minutes, as the office is less than 2 miles away. Depending on the client site, my commute could be much longer, as traffic in Houston has congestion at most hours of the day.

k. Where will you do your grocery shopping?

If in Atlanta, there is a Trader Joe’s that is 0.8 miles away from Skyhouse Buckhead, which would require a 5-minute drive or less. If in Houston, there is a Trader Joe’s that is 2.5 miles away from where I would live, which would be about a 15-minute drive.

l. How will you do your laundry?

Both properties offer in-house laundry machinery within the apartments. If in Atlanta, there is a Dry Cleaners less than half a mile from my apartment. If in Houston, there is a dry cleaner near the grocery store and is less than two miles away from AMLI City Vista.

m. Name at least three civic, religious, or charitable organizations you would like to be in for each city.

Whether in Atlanta or Houston, I would like to be a part of KPMG’s Family for Literacy (KFFL) organization, which focuses on literacy at the prekindergarten and elementary stages. If in Atlanta, I would be a parishioner of the Cathedral of
Christ the King Catholic Church, as well as being a member of the Atlanta Women’s Club or the Junior League of Atlanta. If in Houston, I would be a parishioner of St. Anne’s Catholic Church, along with being a member of the Junior League of Houston.

n. What are the sports, entertainment, or recreation activities that you would be most likely to engage in within the city? Name at least five activities.

If in Atlanta, I would be a member of the Orangetheory Fitness studio in Buckhead. Additionally, I would likely enjoy the Atlanta Braves baseball games and the Atlanta Falcons football games. Atlanta has several music festivals each year, so I would most likely attend the Music Midtown Festival. There are numerous entertainment venues for live music, as well, such as the State Farm Arena, where internationally-renowned artists play. If in Houston, I would be a member of the Orangetheory Fitness studio in Montrose, which is less than two miles from my apartment. I would engage in sports activities like watching the Houston Texans football team, the Houston Rockets basketball team, and the Houston Astros baseball team. Additionally, Buffalo Bayou Park is near where I would live, and offers 124 acres of green space where I would be able to take my dog and experience recreation.

o. What are the modes of traveling back to your hometown from this city?

What is the average cost you’d incur for each trip back home?

To travel to my hometown—Little Rock, AR—from Atlanta would require either an eight to 9-hour drive of 540 miles or a direct flight from Hartsfield Jackson to Clinton National Airport, which averages at about $200-250 round trip. I would
most likely fly home. Flights from Houston to Little Rock average at about $275-350 for a roundtrip ticket. However, driving from Houston to Little would be a 500 mile, eight to 9-hour drive as well. Depending on flight prices and the duration of my stay at home, I would either drive or fly.

p. **Based on your findings, develop a model monthly operating budget for each city for Year 2, assuming that with bonuses for being a high performer, your annual salary is $60,000.** Finally, based on your full analysis, determine whether you still want to live in both cities, and if so, which one is your preferred city and why?

After creating a monthly budget, I concluded that it would be cheaper to live in Houston, as the cost of living would be cheaper and many expenses I would be splitting with my sister. However, I would much rather live in a city similar to Atlanta due to climate, weather, and topography. Additionally, Atlanta’s International Airport makes travelling less expensive and easier with more direct and nonstop flights to places all around the world. However, Houston would allow for me to live with my sister and be close to other family, meaning I would only incur expenses when travelling to see my parents rather than having to travel to see my sister, as well, which would happen if I were to live in Atlanta. Overall, I am still open to living in both cities, as they are similar in many ways and both have much to offer relative to what I value for where I would like to start my career.
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CASE 12: CAPITALIZED COSTS & EARNINGS QUALITY
WorldCom, Inc.

November 16, 2018
This case examined the financial statements and notes for WorldCom, the global communications services firm that was known for its downfall in 2002 as the result of inflating net income by recording “line cost” expenses as investments. Soon after this was uncovered, the telecommunications giant filed for bankruptcy, and this scandal, along with the uncovering of Enron, led to the Sarbanes-Oxley Act in July 2002. In addition to the financial statements, I utilized external sources, including an article from *The Wall Street Journal* on WorldCom’s “cooked” books. While utilizing the FASB Codification, specifically relating to the topics of expenses and assets in FASB Statement of Concepts No. 6, *Elements of Financial Statements*, I acquired a more technical understanding of the definitions of costs that should be capitalized versus costs that should be expensed. With this technical understanding, I was able to differentiate between costs that WorldCom should and should not have capitalized on its financial statements, as this difference is critical for avoiding material misstatement and reporting accurate financial statements. Overall, this case enhanced my technical knowledge of accurate and inaccurate capitalization of a company’s costs. This technical knowledge, along with being able to decipher the accuracy of capitalization via notes and disclosures related to the financial statements, will help me as a future auditor, as I will likely be auditing public companies that may not be producing quality, accurate financial statements. Understanding and analyzing the significance of uncovered misstatements will help me when assessing materiality and whether the exceptions were caused by human error or were intentional.
a. FASB Statement of Concepts No.6 (a replacement for SCON No. 3), *Elements of Financial Statements*, describes the building blocks with which financial statements are constructed.

i. Explain how SCON 6 defines “asset” and “expense.”

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. Expenses are outflows or other using up of assets or incurrence of liabilities, or a combination of both, from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity’s ongoing major or central operations.

ii. In general, when should costs be expensed and when should they be capitalized as assets?

In general, costs should be expensed when they have no future economic value or when they have expired or been used up. Costs should be capitalized or recorded as assets when the costs have not expired and they still have value to the firm.
b. What becomes of “costs” after their initial capitalization? Describe, in general terms, how the balance sheet and the income statement are affected by a decision to capitalize a given cost.

When costs are capitalized, they become part of fixed assets. Therefore, the fixed assets section of the balance sheet increases. If costs are capitalized, then the cost is not yet recognized on the income statement, therefore increasing revenues for the current year. When costs are capitalized, the future years’ expenses will be more consistent, resulting in a smoother pattern of reporting net income. After initial capitalization, depreciation will be expensed.

c. Refer to WorldCom’s statement of operations. What did the company report as line costs for the year ended December 31, 2001? Prepare the journal entry to record these transactions for the year. Explain, in your own words, what these “line costs” are.

| Line Cost Expense | 14,739,000 |
| Cash             | 14,739,000 |

These “line costs” were for telecom access and transport charges, but were booked as capital expenditures.

d. Refer to the Wall Street Journal article. Describe the types of costs that were improperly capitalized at WorldCom. Explain, in your own words, what transactions give rise to these costs. Do these costs meet your definition of assets in part a above?

WorldCom improperly booked $3.8 billion of expenses. Portions of their line costs were improperly capitalized. The definition of “line costs” filed with the SEC costs of access charges and transport charges paid to service providers.
WorldCom’s line costs totaled $8.12 billion for 2001, as reported on its income statement. While companies can often times capitalize costs related to installation and labor, the magnitude of the capitalization by WorldCom was far beyond the capitalization of its industry competitors. These costs do not meet the definition of assets from part a, as not all of the line costs were generating revenues.

e. Prepare a single journal entry to record the improperly capitalized line costs of $3.055 billion for the year. Where did these costs appear on the balance sheet? Where on the statement of cash flows?

Property and Equipment 3,055,000,000
Line Costs Expense 3,055,000,000

The line costs appear in the balance sheet as Property and Equipment, one of the categories of assets. These costs appear on the statement of cash flows as a cash outflow used in investing activities, as property and equipment increased.
f. In a sworn statement to the Securities and Exchange Commission, WorldCom revealed details of the improperly capitalized amounts (in millions) in 2001: $771 in the first quarter, $610 in the second quarter, $743 in the third quarter, and $931 in the fourth quarter. Assume that WorldCom planned to depreciate these capitalized costs over the midpoint of the range for transmission equipment as disclosed in note 1. Further assume that depreciation begins in the quarter that assets are acquired (or costs capitalized). Calculate the related depreciation expense for 2001. Prepare the journal entry to record this depreciation.

\[
\begin{align*}
771/22 \times \frac{4}{4} &= 35,045,455 \\
610/22 \times \frac{3}{4} &= 20,795,455 \\
743/22 \times \frac{2}{4} &= 16,886,364 \\
931/22 \times \frac{1}{4} &= 10,579,546
\end{align*}
\]

Total Depreciation = $83,306,820

\[
\begin{align*}
\text{Depreciation Expense} &\quad 83,306,820 \\
\text{Accumulated Depreciation—Property} &\quad 83,306,820
\end{align*}
\]
g. Use your answers to parts e & f above to determine what WorldCom’s net income would have been in 2001 had line-costs not been improperly capitalized. Use 35 percent as an approximation of WorldCom’s 2001 marginal income tax rate in your calculations. State any other assumptions you make. Is the difference in net income material?

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