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A COMPREHENSIVE EVALUATION OF ACCOUNTING METHODS AND APPLICATIONS THROUGH CASE STUDIES

by Dorothy Anna Meachum

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, MS
May 2020

Approved by:

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Advisor: Dr. Victoria Dickinson

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ABSTRACT

DOROTHY MEACHUM: A Comprehensive Evaluation of Accounting Methods and Applications Through Case Studies
(Under the direction of Dr. Victoria Dickinson)

This following thesis is a compilation of the case studies assigned by Dr. Victoria Dickinson, in fulfillment of the requirements for the University of Mississippi, Sally McDonnell Barksdale Honors College, and the Professional Research and Development Thesis Program. Each of the twelve case studies pertains to a different topic or problem concerning the application of accounting standards, accounting principles, or financial statement preparation and analysis. In addition, these cases present the application of accounting studies to real world scenarios, incorporating various fields such as finance, investments, risk assessment, and economics. Each of the financial cases introduced a company using their financial statements and accounting position, which were utilized for better understanding of the topic at hand. After learning more about each company, students would answer questions in order to better analyze the company's situation and understand the given topic. By the completion of this course, students increased their critical thinking and problem-solving skills, gained a thorough understanding of U.S. Generally Accepted Accounting Principles and the Financial Accounting Standards Board, and prepared for their future career as a public accountant.

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Case 1: Data Analytics – IBM Watson

Executive Summary

Accounting is a constantly evolving industry, thanks to the emerging technology that makes the field more efficient as a whole. The biggest change in recent history has been the addition of data analytics and data analytics processors that are available for accountants to use to make nearly all aspects of their jobs more precise. “Big data” describes the growing size and complexity of the modern data that is out there in today’s world. There is too much of it for humans to sift through and decipher what is important and what is not, all while doing their job alongside it. On top of that, there is more data coming out now than ever before, at a rate that humans cannot keep up with. That is where data analytics processors, such as IBM Watson, come in. These programs can process millions and millions of articles, spreadsheets, or any other kind of data in a matter of seconds. This lets employees using one of these programs to make more informed business decisions.

Before researching IBM Watson, I had a surface level knowledge of data analytics, but had no idea about any of the programs that were a part of it. After looking more into Watson, I was impressed with how useful it could be and how easy it was to actually use it. I also figured that because we were researching these tools for our class, that they were only relevant to the accounting industry. I was surprised to see that these data analytics programs could be utilized in all different types of work, from finance to medicine to government. In short, I learned that data analytics is the future of all businesses. While I’m kind of ashamed to admit I didn’t know much about this field before researching this, I’m glad that I know about it now.

Case Analysis

Identify the purpose of this tool and describe, in general, how it is used to make business decisions.

IBM Watson is a data analytics processor that uses natural language processing, a technology that analyzes human speech for meaning and syntax. Watson was created with augmentation in mind; its main purpose is to form greater collaboration between humans and systems. This program, developed in 2010 and made available for commercial use in 2014, performs analytics on repositories of data that it processes to answer questions posed by humans quickly and efficiently, often in a fraction of a second. (It can read and process 800 million pages of data per second.) Watson was created in response to the lack of AI in the workplace, because most AI was being developed by social media companies like Google and Facebook.

What distinguishes Watson from other data analytics processors is how directly relevant it is to problem solving in the office. Businesses can integrate Watson's AI into their everyday business processes, making it much more efficient to find and analyze data. Today, Watson is being used in many different professions, such as the financial industry, healthcare, cybersecurity, and even fashion. There are many different examples of this. One example is a doctor who can give Watson the symptoms or conditions a patient is facing and have Watson give a diagnosis. Another example is a data scientist who must develop algorithms and queries and can use Watson to help derive their answers. While most employees that utilize Watson are in the data analytics division of their company, the program is user friendly enough that nearly anyone can use it.

1. **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.**
    - **Auditing**
        - Watson can aggregate industrywide data (information from publicly traded companies or industry data aggregators) to determine averages and/or standard deviations of revenue streams, cost of production, net margins or seasonal trend cycles. An auditor can then use this information for comparison purposes against the company its auditing for material deviations. If there are large deviations, then it may signal an issue or potential impropriety. If the company is underperforming vs. the industry at large, the deviation could signal a potential opportunity for corporate improvement.
        - Companies can use Watson to look at a company's transaction level data and quickly compare to legal, country, state or county legal requirements to determine potential legal or compliance issues.
        - While using Watson, time spent searching for inconsistencies in data sets will be minimized, and employees can spend more time where human judgment is more needed: critical analysis and exercising judgment. Companies have the chance of facing large fines if they make large mistakes in external auditing, and

companies that use Watson would minimize these mistakes. These tools can reduce costs up to 75 percent in some financial processes.

- **Tax Planning**
  - Watson can be utilized to analyze a company's transaction level data to determine whether a company is appropriately paying/reserving for federal, state and local taxes on a transaction-by-transaction basis.
  - Companies that use Watson can quickly analyze where their sales are being made regionally to allow a tax planner to recommend whether a company should be domiciled to minimize corporate, real estate and/or franchise taxes.
  - Using Watson, companies can perform tax planning by combining structured and unstructured data. This means that they can use all of the information that they have on hand, as well as having access to all big data, and compile more precise analyses. Big data is nearly impossible to compile and make use of with only humans on the task, so it would make a large difference in this sense.
  - Companies can use Watson to track real time tax rates. For companies that engage in business over state lines or internationally, this is important to be aware of how taxes are

changing all around the world. These companies can also compare tax rates with what they were a year ago, or even yesterday.

2. **Write a few paragraphs 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 engagements.**

To: Partners of Big Four Firm

From: Dorothy Meachum

Date: 8/29/2018

Subject: IBM Watson Research

As a company, I believe that we would benefit greatly if we started using IBM Watson as our data analytics tool. After doing some research, I have come to the conclusion that it is necessary that we implement a data analytics processor to our company in today's world. With big data becoming much more prevalent in everyday business, our company needs to keep up with the newest and most innovative technology available. Our data analyses can become much more precise and error free if we can rely on Watson to sort through data and answer questions for us. As far as data analysis tools go, IBM Watson was one of the original AIs for businesses. While Watson can be expensive if you buy the system itself, it is also available on the cloud, which is a much cheaper option for nearly the same value. Watson is also incredibly user friendly, so it would be easy to train employees to use it, and it would be very accessible for everyone in the company.

Watson would impact our business by streamlining many processes involving both internal/external audit and taxes. Watson would allow our employees to avoid doing the laborious task of compiling and organizing data, because the program would do that part for them. Then, our employees could spend more time doing what they are qualified for, which is analyzing the data. Watson could help us track trends and find inconsistencies in data with fewer errors and with less effort involved. The scope of our future engagements would be able to be much larger because we can work with much more information than in the past. With a processor like Watson, we would have large amounts of data at our fingertips. Please consider investing in IBM Watson, for the sake of our company and for our future.

Case 2: Rocky Mountain Chocolate Factory, Inc. – Statement of Cash Flows

Executive Summary

The purpose of this case was to get a better understanding of how real-world financial statements work. Through the completion of the general ledger spreadsheet, I was able to visualize and understand a company's full accounting cycle when preparing financial statements and journal entries. By having to hyperlink accounts from the journal to the income statement, balance sheet, and cash flows, it was easy to see how connected they all are. Additionally, I was able to properly classify the different operating, investing, and financing activities of Rocky Mountain Chocolate Factory based off of the journal entries I made.

With this case, I feel like I have a better grasp of how auditing actually works in the real world. I liked using Excel because I always questioned why we do every single thing on paper in our accounting classes, when the reality is that most people haven't done that since technology allowed more efficient means. I have a better sense of the similarities and differences in financial statements, and how they are used for a company. I definitely had a bigger sense of accomplishment upon finishing this than if I had done it on paper.

Case Analysis

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?**

   On the balance sheet, I expect to see cash, accounts receivable, accounts payable, inventories, salaries and wages expenses, unearned revenues, dividends, and common stock. The major assets will be cash, accounts receivable, and inventories. The major liabilities will be accounts payable, salaries and wages expenses, dividends, and unearned revenues.

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.**

   Like most companies, Rocky Mountain Chocolate Factory will have to make some adjustments before completing their financial statements. Adjustments that may need to be made on the journal include depreciation and amortization expense, deferred income, and accrued salaries and wages.

Figure 2-1: Rocky Mountain Chocolate Factory, Inc. General Ledger

General Ledger			
1	Inventories	7,500,000	
	Accounts Payable		7,500,000
2	Inventories	6,000,000	
	Accrued Salaries & Wages		6,000,000
3	Cash	17,000,000	
	Accounts Receivable	5,000,000	
	Sales		22,000,000
	Cost of Sales	14,000,000	
	Inventories		14,000,000
4	Accounts Payable	8,200,000	
	Cash		8,200,000
5	Cash	4,100,000	
	Accounts Receivable		4,100,000
6	Sales & Marketing	1,505,431	
	General & Administrative	2,044,569	
	Retail Operating	1,750,000	
	Cash		2,000,000
	Other Accrued Expenses		3,300,000
7	Accrued Salaries & Wages	6,423,789	
	Cash		6,423,789
8	Cash	125,000	
	Deferred Income		125,000
9	Property & Equipment	498,832	
	Cash		498,832
10	Retained Earnings	2,407,167	
	Dividends Payable		3,709
	Cash		2,403,458
12	Cost of Sales	216,836	
	Inventories		216,836
13	Depreciation & Amortizati	698,580	
	Property & Equipment		698,580
14	General & Administrative	639,200	
	Retail Operating	6,956	
	Accrued Salaries & Wages		646,156

Figure 2-2: Rocky Mountain Chocolate Factory, Inc. Income Statement

Rocky Mountain Chocolate Factory Income Statement For Year Ended 2/28/10		
Account	**Balance**	
Revenues		
Sales	$	22,944,017
Franchise and royalty fees		5,492,531
Total revenues	$	28,436,548
Costs and Expenses		
Cost of sales		14,910,622
Franchise costs		1,499,477
Sales & marketing		1,505,431
General and administrative		2,422,147
Retail operating		1,756,956
Depreciation and amortization		698,580
Total costs and expenses		22,793,213
Operating Income	$	5,643,335
Other Income (Expense)		
Interest expense		0
Interest income		27,210
Other, net		27,210
Income Before Income Taxes	$	5,670,545
Income Tax Expense	$	2,090,468
Net Income	$	3,580,077
Basic Earnings per Common Share	$	0.60
Diluted Earnings per Common Share	$	0.58
Weighted Average Common Shares Outstanding	$	6,012,717
Diluted Effect of Employee Stock Options	$	197,521
Weighted Average Common Shares Outstanding, Assuming Dilution	$	6,210,238

Figure 2-3: Rocky Mountain Chocolate Factory, Inc. Balance Sheet

Rocky Mountain Chocolate Factory
Balance Sheets
For Year Ended 2/28/10

Account	Balance	
Assets		
Current Assets		
Cash and cash equivalents	$	3,743,042
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	$	12,224,486
Property and Equipment, Net		5,186,709
Other Assets		
Notes receivable, less current portion		263,650
Goodwill, net		1,046,944
Intangible assets, net		110,025
Other		88,050
Total other assets		1,508,669
Total assets	$	18,919,864
Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts payable		877,832
Accrued salaries and wages		646,156
Other accrued expenses		946,528
Dividend payable		602,694
Deferred income		220,938
Total current liabilities		3,294,148
Deferred Income Taxes		894,429
Commitments and Contingencies		
Stockholders' Equity		
Preferred stock		
Series A Junior Participating Preferred Stock		
Undesignated series		
Common stock		180,808
Additional paid-in capital		7,626,602
Retained earnings		6,923,927
Total stockholders' equity	$	14,731,337
Total liabilities and stockholders' equity	$	18,919,914

Figure 2-4: Rocky Mountain Chocolate Factory, Inc. Cash Flows

Cash Flows

Transaction	Section of Cash Flows
1. Purchase inventory	Operating
2. Incur Factory wages	Operating
3. Sell inventory for cash and on account	Operating
4. Pay for inventory	Operating
5. Collect receivables	Operating
6. Incur SG&A (cash and payable)	Operating
7. Pay wages	Operating
8. Receive franchise fee	Operating
9. Purchase PPE	Investing
10. Dividends declard and paid	Financing
11. All other transactions	N/A
12. Adjust for inventory count	Operating
13. Record depreciation	N/A
14. Wage accrual	Operating
15. Consultant's report	N/A

Case 3: Transparency and Ethics

Executive Summary

In this case, our class explored three separate scenarios of Patterson Accountancy students who were planning on completing an internship with a firm. We were then told to pick a side, and then debate if we agreed or disagreed with the students. The common thread between each of the three scenarios was that the students involved were taking the internship opportunities that we are given here at Ole Miss for granted. The students all planned on doing one of the senior year internships at an office with no intent to follow through and work for the firm long term.

Case Analysis

The first scenario involved two students talking in Conner Hall about future opportunities. One student mentions that they want to go to law school and eventually get involved in tax law. The other student is confused, asking if they are still planning on doing their internship in the spring of their senior year. The first student doesn't hesitate to answer that they are planning on doing their internship, but do not plan to accept the job offer upon graduation. For him, the internship would serve as a resume booster to aid his efforts of being accepted into a top law school.

While I understand this student majoring in accounting as a means to get into tax law later on, I don't think he went about this in the right way. It would have been better if he had been transparent with the firms throughout the recruiting process. Even though this may have hindered his chances of getting an internship offer, it doesn't sound like he wants the internship as an opportunity to secure a job for after graduation. Because of this, he may have taken the spot of a student who is eager to get into public accounting post-grad.

The second scenario involved three students talking in Conner Hall about their plans upon graduation. One student is planning to work for a firm for a few years and then go into consulting, another student plans on going into investment banking after graduating from Ole Miss, and the other student doesn't say much.

There are many students in the Patterson School that sympathize with these students. Public accounting is a great way to get one's foot in the door of the corporate world, and these students understand that. They talk about how they will work in public accounting for the beginning of their careers, which is only fair to the firm that they will

ultimately sign with. The firms pour a lot of resources into recruiting and training their staff, whether it be time or money, and the payback period of around three years is a very real thing. This scenario emphasizes an important message: while it is okay to enter a new career path, it is important to give back to one's firm before doing so.

The third and final scenario involves an email exchange between a graduate student at Ole Miss and Dr. Dickinson. The student did his senior year internship with a Big Four firm in Washington, D.C., but decided that D.C. wasn't for him. He is trying to get a transfer to Dallas, where he is from. He is seeking the advice of Dr. Dickinson on the matter. She thinks he should reach out to the firm, but it may not happen immediately. The other more realistic option is to work for the D.C. office for a year or two and then request a transfer, because Dallas is a very competitive office.

This scenario hit home for me. I am from Dallas, but I have decided that I want to pursue an internship in Atlanta, GA. I'm extremely excited about going to a new city, but it would be nice to know that there is still an option if I somehow decide that I can't live anywhere else besides Dallas. I think that this student should have been upfront with his recruiter about how his internship went in his new city. Even though there's a possibility that he would be able to transfer to Dallas, it would have been more likely had he voiced his concerns immediately and not waited a year. This scenario highlights the importance of taking one's choice of city seriously. While it may be fun to live somewhere for a few months, it's important to pick somewhere where you could live for years after graduation.

I feel like this discussion and subsequent case have been incredibly eye opening for me. Before our discussions, I thought that a student could do what they wanted as long as they worked hard and made themselves attractive to a firm whether they ended up

staying or not. While I still believe that somebody can do anything if they are a high enough performer, it's important to look at these three scenarios, and the general situation, from three different perspectives. Like I stated earlier, the student will end up looking out for their best interest most of the time. If they are getting an offer to many firms, they will accept the one that is the best opportunity for them. If they want to transfer somewhere else and are a high enough performer that they can do that, they will have that opportunity. If they want to leave and go do investment banking, it's up to them. A lot of these people will never think about the consequences of their actions.

On the flip side of this are the other two perspectives. The Patterson School of Accountancy is a top ten program in the nation for accounting, and they have held that position for many years now. This school is attractive to firms looking to hire young students. One thing that makes it less attractive is when students do an internship and then do not follow through to work for the firm afterwards. In turn, that looks bad on the Patterson School. I think that this school has poured enough into its students, especially its top ones, from recruiting us through senior year even after our graduation from Ole Miss. We owe it to them to give back what we can, and if that is working a job for three years that we agreed we would, then we should commit and follow through with that.

The last perspective I will look at is the viewpoint of the firms. Dr. Dickinson told us how much a firm will spend on each student through the recruiting process and then with training once they commit to the firm: $175,000. That is so much money to be spending on someone in college, and I think it is disrespectful for a student to throw that all away with giving nothing to the firm in return. I think that even if a student wants to go into consulting after college, they should work for the firm at least for the payback

period (two to three years). Most jobs are not paying a recent college graduate the amount of money a newly minted CPA gets. At the end of the day, I think that the students should have the same outlook on the Patterson School as well as the firms: give back to a place that has given so much for them. I believe that if more students carry that mindset, then Ole Miss will continue to have a top accounting program as well as having firms that line up to hire their graduates.

Case 4: Generic Bank – Accounting for Debt Securities Sales and Impairments

Executive Summary

This case looked at Generic Bank, focusing on the accounting rules for debt securities with an emphasis on impairment. The bank is looking to sell securities to gain liquidity for potential growth in the future and for employees' year-end bonuses. Taking the roles of a banking executive, external auditor, and bank regulator, the students needed to determine if certain securities sold were impaired using proof from ASC 326-30. While there were concrete answers for some of the questions, many of them were vague and up to interpretation. As long as the student could back up their answer, they could come to different conclusions and still be considered correct.

From completing this case, I learned a lot about debt securities, specifically Available for Sale, and impairment, which are subjects I had never even heard of before starting this. I learned how to figure out if a specific security was impaired based on if the fair value of the security was less than its amortized value due to changes in interest rates, not credit loss, and that the bank had no intent to hold these securities until they could recuperate the loss back. I got to put myself in many different roles in the financial field and analyze these situations from many different viewpoints. Aside from the topic itself, I learned how to use the FASB Codification to come to a conclusion that may not be as concrete as some other aspects of accounting.

Case Analysis

1. **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?**

   Generic bank does have an impairment loss on the seven securities. According to ASC 326-30, an investment is impaired if the fair value of the investment is less than its amortized cost basis. The securities with CUSIP ending in 003, 015, 025, 030, and 076 all had fair values that were less than their amortized costs. The securities with CUSP ending in 067 and 096 had fair values that were greater than their amortized cost, so there was no impairment on these securities. This impairment loss was not due to credit loss, but because the bank had no intent to hold these securities. While the bank originally stated that it had the intent and ability to hold unrealized loss debt securities until they can recover the amortized cost basis, that fact became null once they sold these securities. The impairment for the seven sold securities should be recorded in 2012. While the bank said that they had the intent to hold these securities, that is made null when the bank sold those securities.

2. **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?**

No, because the bank has the opportunity to hold these securities until maturity. Because of this, they do not face an impairment loss on securities other than the seven securities sold. The bank has other ways to raise capital, so the extent of the impairment is only on those certain securities sold. Also, according to the ASC 2016-13, the separate contracts cannot be aggregated together because of their different CUSIP numbers. This means that it cannot determine if a debt security is impaired or not.

3. **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?**

As an external auditor, the answer would not change. If the security's fair value is less than its amortized cost due to changes in interest rates, not credit loss, and the bank has no intent to hold the security, then the security would still be considered impaired.

From the viewpoint of the bank regulator, they would advise the bank to report the loss if they had even the slightest intention of selling the securities. Since bank regulators make decisions based on a strict code of ethics, they would believe that it's better to report it just in case. Also, the bank regulator should consider that there are subjective factors that come into play, so they should scrutinize the potential need to sell securities a bit closer than Generic Bank would. They should analyze the market climate, interest rates, and other factors that might lead to the bank's need to sell securities.

4. **How would your assessment of the existence of an impairment in both requirements 1 and 2 change if the securities sold had been collectively in a net gain position? What if all the securities sold were in gain positions?**

   Even if there was a collective net gain on the securities, five of the seven securities had an individual impairment loss. While there were individually impaired losses, as a whole the bank has the opportunity to report a gain on the sale. However, this could be considered as gains trading because they would not be reporting the individual losses but instead just reporting on the big picture. According to the FDIC, gains trading is defined as "the purchase and subsequent sale of a security at a profit after a short holding period, while securities acquired for this purpose that cannot be sold for a profit are retained in the AFS or HTM portfolio". The bank would be better off reporting all of the individual losses, because that does not negate the fact that they had a net gain position. It would only benefit the bank to report both their losses along with their net gain, because it more fairly portrays their financial situation. If all of the individual securities were sold in gain positions, then there would be no impairment. The bank would be making a profit of off all of the securities, therefore having no question about the net gain position.

5. **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 Generic Bank is adequately capitalized rather than well capitalized, they will probably need to expect to sell more securities. They would be required to

sell more securities in order to produce more funds than if they were well capitalized, so they will have end up having a greater impairment loss than only those seven securities originally sold. According to ASC 326-30-35-10, “if an entity does not intend to sell the debt security, the entity shall consider available evidence to assess whether it more likely than not will be required to sell the security before the recovery of its amortized cost basis”. Given this information, the bank will be likely required to sell these securities to make up for the fact that they are not well capitalized.

Case 5: Analysis of Potential Career Cities

Executive Summary

In this case, I was tasked with researching the two cities I am most considering starting my career and living after college. Everyone has different cities that they are interested in working in after college, and this case was a great opportunity to get a little more in depth about if those cities are realistic to live in. This case looked at many different aspects of a city, a few examples being taxes, climate, and budgeting. The two cities I chose were Washington, D.C. and Atlanta, GA. Before completing this research on the two cities, I considered them to be equally good options for me post-graduation. I was able to compare and contrast many different aspects of city life, including climate, health care, and transportation. I believe that conducting this research was instrumental in me ultimately deciding on Atlanta as my future home, and I think it would be good if the Patterson School were able to implement some sort of research requirement before students choose their internship city. It's important to understand the city that you choose for your internship, because the firm that you sign with expects you to come back to work at that office upon graduation. Now, I have done the research to back up why I chose Atlanta.

While all of the cases have been a good learning experience for my future, this one in particular had a tangible aspect to it. Though I have known where I've wanted to move after college and this case didn't change that, friends who also completed this case are rethinking where they would like to go. Some of the questions seemed a little tedious to answer, but I'm glad I had to, because it made me consider things that wouldn't have even occurred to me. One of the biggest examples of this was the tax rates in my cities. Even though I know that not everywhere has the same tax rates, I didn't realize how this

would affect my operating income for the years to come depending on where I choose to live. That, among all of the other questions, is something to seriously take into consideration when choosing where to locate myself in a few short years.

Questions

1. **What is the population?**

In 2017, Atlanta's population was approximately 487,000 in the city itself, and 5.8 million in the metropolitan area. As of July 2017, the city of Washington, D.C. had a population of 694,000, but the greater metropolitan area raises that population to 6.1 million.

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

Atlanta is a city that sees all four seasons. In the summer, it can get very hot and humid; in the winter, it is cool, with an average of 48 freezing days per year. Like most of the south, Atlanta receives generous precipitation year-round. Like Atlanta, D.C. has its four distinct seasons. The summers are hot and humid, and the winters are chilly with light snow; spring and fall are both mild to warm for the most part. Blizzards are known to hit the city once every four to six years, on average.

3. **Describe the city's topography, scenery, and other geographical/geological features of the area in which the city is located. (Include pictures where appropriate!)**

Atlanta is situated at the foothills of the Appalachian Mountains, with an elevation of 1,050 ft. The city is south of the Chattahoochee River, and much of the river's natural habitat is preserved as a recreation area. The Potomac River is on the edge of the Washington, D.C., dividing D.C. from Virginia. The city's elevation is between 0 and 409 ft, depending on what part of the city is measured. Washington, D.C. has the

second highest density of parks among high-density cities in the United States, totaling 19 percent of the city.

4. What are the individual tax rates within the city?

Within the city of Atlanta, the marginal tax rate for someone making $50,000 is 6 percent marginally, but the effective tax rate would be 5.3 percent. Add that to the federal tax rate and FICA, I would be paying (with the 2017 tax rate) $12,112 in taxes per year. Washington D.C.'s marginal tax rate for a salary of $50,000 is 6.5 percent marginally, but the effective tax rate would be 4.79 percent. Add that to the federal tax rate and FICA, and I would be paying (with the 2017 tax rate) $11,860 in taxes per year.

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

Atlanta is home to the busiest transportation hub in the world: Hartsfield-Jackson International Airport. This airport has held this title consecutively since 2000, with nearly 104 million passengers coming through annually. One of D.C.'s largest transportation hubs is Union Station, a central location with stops for AmTrak, the Metro, buses, and taxis. Washington Dulles International Airport is the region's largest airport, located 26 miles west of downtown Washington, D.C.

6. What is the city's most prevalent industries?

Atlanta is a city with one of the top twenty largest economies in the world. It has a good mix of different industries, hosting the third most Fortune 500 companies in the

United States. Some of its biggest corporations are Coca-Cola, Delta Airlines, Home Depot, Chick-fil-A, and UPS. Atlanta has become a hub for media, with a rise in recent history. CNN and TBS were both founded in Atlanta, and many television and film productions are turning to Atlanta for filming locations. D.C. is home to the sixth-largest metropolitan economy in the United States, which is increasingly diversifying. More than 25 percent of the workforce in Washington, D.C. is employed by a federal governmental agency. Tourism is the city's second largest industry, with Washington being one of the most visited cities in the world. There are many foreign embassies and international organizations headquartered here, contributing an estimated $400 million to the economy.

7. **Describe the quality of the city's healthcare.**

   In a ranking of all of the states and their healthcare quality, Georgia is ranked 6th to last in quality healthcare. As far as cost of healthcare, they are ranked 38th. On the same ranking that Georgia scored 6th worst healthcare, Washington, D.C. ranked 5th best. For the cost ranking, D.C. scored 1st, so they have the most affordable healthcare in the country.

8. **What types of crime are common within the city and where are the locations within the city to avoid?**

   Atlanta is a city that used to be known for crime. It has made major headway from this reputation though, with a 40 percent decrease in the city's crime rate between 2001 and 2009. National crime rates are decreasing, but Atlanta's is decreasing at

more than twice the rate of the national average. The most common crimes in Atlanta have to do with gangs and drug abuse. Atlanta has become a major transportation hub for human trafficking; it is ranked in the fourteen highest cities in the U.S. for levels of sex trafficking. In D.C., the most common crimes in are associated with theft, drug abuse, and gangs. This crime is mostly seen in the eastern part of the city, with 5 percent of the city blocks accounting for over ¼ of the city's total crime.

9. **Based on where you see yourself living for the first three years, how much rent do you expect to pay? *include sample properties from each location (pics)* Describe the square footage, need for a roommate, available parking, etc.**

In Atlanta, I would look to rent an apartment that would cost ~$1,500/month and live with a roommate to mediate costs. I'm only looking at apartments that have available parking, washers and dryer in the unit, and are around 950-1200 square feet.

Property 1 (Post Chastain Apartments, Midtown)

- 2 bed, 2 bath
- 1,072 square feet
- $1,580/month ($790 per person)

Property 2 (Savannah Midtown)

- 2 Bed, 2 bath
- 1204 square feet
- $1,690/month ($845 per person)

After researching neighborhoods and apartments in Washington, I think I would rent an apartment in Columbia Heights or Foggy Bottom. This would cost me ~$3,200/month for a 2 bed 2 bath apartment, so I would definitely need to get a roommate to split the cost. The apartment would have available parking, washer and dryer in unit, and are around 950-1100 square feet.

Property 1 (Highland Park at Columbia Heights)

- 2 bed, 2 bath
- 1,130 square feet
- $2,910/month ($1,455 per person)

Property 2 (Allegro Apartments in Columbia Heights)

- 2 bed, 2 bath
- 1,086 square feet
- $3,382/month ($1691 per person)

10. What is the typical mode of commuting? What are your likely commute times?

While Atlanta does have a rapid transit system (MARTA), most people drive to work, as shown by Atlanta's horrendous traffic into downtown. I would plan on living in Buckhead though, so my commute should not exceed twenty minutes each way. D.C. is a city built on public transportation. Lots of people do not have cars, and they get to work and anywhere else they need to go by Metro. Based on where the

apartments I looked at and the Big 4 offices are in D.C., my commute time on the Metro would be anywhere from 21 to 35 minutes every morning.

11. Where will you do your grocery shopping?

Atlanta has a variety of grocery stores. I did my research looking at grocery stores near the apartments that I scouted out. Closest to where I plan to live, there is a Publix, Kroger, Whole Foods, and Trader Joe's. I will probably do most of my grocery shopping at Publix or Trader Joe's, while making specialty trips to Whole Foods when there is something I need there that I cannot find at the others. The major chains of grocery stores in D.C. include Trader Joe's, Whole Foods, Safeway, and Harris Teeter. They have all of these in the neighborhoods I was looking at, and I will most likely do most of my grocery shopping at Trader Joe's and Safeway. Like Atlanta, I will go to Whole Foods on special occasions when I need certain things there.

12. How will you do your laundry?

I will use a washer and dryer in my apartment, because one of the filters that I used when looking at apartments.com was that the unit must have a washer and dryer. Like Atlanta, I only looked at apartments that have a washer and dryer in unit. Because of the long hours I will surely be working my first few years, I want to know that laundry is one thing I will not have to worry about.

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

I would probably join the church that much of my family in Atlanta attends and the head pastor at my church in Dallas came from, Peachtree Presbyterian Church. I would most likely join a charitable organization, such as the Atlanta Women's Club. Another thing I would like to do is become a Make-a-Wish volunteer in Atlanta. My list is pretty similar for both cities. The first thing I would do in Washington, D.C. is join a church (Presbyterian). Also, I would like to become a Make-a-Wish volunteer for Make-a-Wish Mid-Atlantic. Another thing I would do is join the Chi Omega Alumnae Club in D.C..

14. What are the sports, entertainment, or recreational activities that you would be most likely to engage in within the city? (at least 5)

Atlanta is one of the cities on the US that has a team for most of the major sports, the Braves (MLB), the Hawks (NBA), and the Falcons (NFL), so there will always be a sporting event to attend. Since Atlanta is such a big city, most musicians stop there on national tours. The biggest concert venues in Atlanta are State Farm Arena and the Masquerade. Besides that, Atlanta is home to the world's largest 10km race, the Peachtree Road Race.

D.C. is in the elite group of only thirteen cities with a team for all four major professional sports: the Nationals (MLB), the Wizards (NBA), the Redskins (NFL), and the Capitals (NHL). When people think of Washington, D.C., they probably think of all of the monuments and museums that are located there. There are far too many to name, but a few include the Smithsonian Museum, the National Gallery of Art, and the Library of Congress. Two major marathons are held in the city, the Marine Corps Marathon (in the fall) and the Rock n' Roll USA Marathon (in the spring).

Completing a marathon is on my bucket list, so maybe living somewhere so close to multiple will convince me to do one!

15. 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?

Atlanta is home to one of the largest airports in the world, Hartsfield-Jackson. Flights between Dallas and Atlanta are very cheap, because they both are home to major airlines (Southwest and American in Dallas, and Delta in Atlanta). Because of this, the airlines all have many flights between the two cities daily, so it's easy to find a cheap flight. The average cost would be ~$250, even with about a month's notice. The drive time between Atlanta and Dallas is right at 12 hours; while not ideal, it's definitely doable if needed.

Because it's nearly a 20-hour drive from D.C. to Dallas, I would definitely be flying home for the holidays. After doing some research, I found that the average round trip flight would be ~$300, which is very manageable. This is assuming that the trip would be planned at least a month in advance.

16. Based on your finding, 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.

Figure 5-1: Atlanta, GA Budget

Item	Cost
Monthly Income	**5,000**
Taxes	**(1,009)**
Savings	**(800)**
Rent	**(790)**
Utilities	**(200)**
Groceries	**(325)**
Dining	**(400)**
Entertainment	**(150)**
Gas	**(105)**
Healthcare	**(240)**
Orange Theory Membership	**(139)**
Other	**(842)**

Figure 5-2: Washington, D.C. Budget

Item	Cost
Monthly Income	**5000**
Taxes	**(988)**
Savings	**(800)**
Rent	**(1,455)**
Utilities	**(170)**
Groceries	**(300)**
Dining	**(450)**
Entertainment	**(150)**
Metro Pass	**(200)**
Healthcare	**(141)**
Orange Theory Membership	**(149)**
Other	**(197)**

17. 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?

I definitely am still interested in both cities. Atlanta is still my preferred city, because it is much cheaper to live there as whole, which this case confirmed. My mom is also from Atlanta, so I have a lot of family in the area. D.C. is a great city as well, and I could see myself living there, but I don't have the same desire to move and work there as I do Atlanta. The only major advantages that D.C. has over Atlanta are the crime rate, which I would be in a safe part of the city, and the healthcare. Other than that, I think Atlanta is the better city for myself overall.

Case 6: WorldCom, Inc. – Capitalized Costs and Earnings Quality

Executive Summary

This case deals with WorldCom, Inc. and the scandal revolving their fraudulent accounting entries. WorldCom was the second largest American telecommunications corporation, founded in 1983, and grew through the acquisition of smaller telecommunications companies. In 2002, WorldCom announced that it has improperly capitalized $3.9 billion over the course of the last five quarters. Because of this, an investigation of WorldCom began, and it ended with their top people being sent to jail and the company filing bankruptcy. Most of the questions in this case come down to the difference between costs that should be capitalized and costs that should be expensed. This was a case covering botched numbers and incorrect financial statements using the biggest real-life example of this.

By completing this case, I learned more about what constitutes capitalized costs vs. expensed costs. Besides learning about some different accounting principles, I understand the WorldCom scandal a lot more now. It makes a lot more sense to me how easy it would be to forge some numbers and have to keep doing it, but also how easy it would be to get caught in the lies.

Case Analysis

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.

a. Explain, in your own words, how SCON 6 defines "asset" and "expense."

Assets are probable future economic benefits obtained or controlled by particular entity as a result of past transactions or events. The three characteristics that an asset must have are: 1) the capacity to contribute to future cash flows, 2) the ability for the entity to control others' access to it, and 3) the transaction for the entity to have possession of the asset must have already happened.

Expenses are outflows or other using up of assets or incurrences 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. For something to be considered an expense, the outflow of assets must have already occurred or is expected to occur.

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

In general, costs incurred to add further value to the asset should be capitalized, but costs that only maintain a given level of service should be expensed.

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.**

After capitalizing costs, a company will have higher total assets. Their reported income will be more consistent from year to year. Capitalized costs will have no effect on the balance sheet. On the income statement, depreciation will be expensed, because depreciation will be happening over a longer period of time.

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. (Journal entries in billions)**

Line Costs Expense	14.739	
Cash		14.739

In WorldCom's case, "line costs" are fees that WorldCom paid other telecommunication network providers in order to be able to access these providers' networks.

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?

Line costs were improperly capitalized at WorldCom and should have been expensed. According to WorldCom's reports, these line costs are mostly comprised of charges for access and transport from third party companies. These costs do not meet the definition of assets because they don't all produce probable future revenues for WorldCom.

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? (Journal entries in billions)

Property, Plant, and Equipment	3.055	
Line Cost Expense		3.055

On the balance sheet, these costs appear under the heading of Property and Equipment, specifically transmission equipment and communications equipment.

On the statement of cash flows, these costs appear in investing activities, as capital expenditures.

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. (Journal Entries in millions)

Depreciation Expense:

771/22 x 4/4 = 35,045,455

610/22 x 3/4 = 20,795,455

743/22 x 2/4 = 16,886,364

931/22 x 1/4 = 10,579,546

Total = 83,306,820

Depreciation Expense	83.307	
Accumulated Depreciation		83.307

G. Use your answers to parts e and f above, to determine what WorldCom's net income would have been in 2001 had line-costs not been improperly capitalized. Use 35% 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?

Income before tax	2,393,000,000
Depreciation for the year	83,306,820
Line costs, improperly capitalized	(3,055,000,000)
Loss before taxes	(578,693,180)
Income tax benefit (35%)	202,542,613
Minority interest	35,000,000
Loss, net	341,150,567

Because the loss is a very large one, the difference in net income is definitely material.

Case 7: Starbucks Corporation – Understanding Financial Statements

Executive Summary

In this case, I researched Starbucks Corporation, a coffee company in the S&P 100. Based out of Seattle, it is a globally recognized chain of coffee shops, known for its expensive roasts and specialty drinks. This case looks at the financial statements of the company between two years and analyzes the details of these statements, including the company's financial wellbeing, estimates, and audit logistics.

This case was interesting to me, because I felt like I was taking the role of a real auditor at a public accounting firm. I was analyzing the financial statements of a global company that I know about and spend my own money at. I learned what to look for when dissecting different financial statements, for example, comparing the debt to the equity and how that may change year to year. Having researched a case like this will be good for my future career, because I will have already seen what it's like to peek behind the curtain and see a large company's financials.

Case Analysis

A. What is the nature of Starbucks' business? That is, based on what you know about the company and on the accompanying financial statements, how does Starbucks make money?

Starbucks started as a pioneer in the "second wave coffee" business; they revolutionized the idea that people should focus on the taste and quality of their coffee rather than just drinking it for caffeine purposes. Started in Seattle in 1971, they now operate over 28,000 coffee shops globally. Their business model is built on the "coffee experience", which makes it worthwhile to pay their premium rather than brewing a pot at home. They serve as both a retailer and a wholesaler of coffee beans and coffee drinks. Starbucks serves as both a retailer and a wholesaler of coffee beans and coffee drinks.

B. What financial statements are commonly prepared for external reporting purposes? What titles does Starbucks give these statements? What does "consolidated" mean?

The external financial statements that are required for GAAP are the Income Statement, Balance Sheet, Statement of Cash Flows, and Statement of Stockholders' Equity. Starbucks calls these statements (in order) the Statement of Earnings, Balance Sheet, Statement of Cash Flows, and Statement of Equity.

These statements are all "consolidated", which means that the financial statements provide an overall view of a company, including its subsidiaries and separate

legal entities. This helps give an indication of the financial health of the overall health of a parent company, including its owned entities. Some of Starbucks' largest subsidiaries include Teavana and Seattle's Best Coffee.

C. **How often do publicly traded corporations typically prepare financial statements for external reporting purposes?**

For external reporting purposes, publicly traded corporations are required to prepare financial statements four times a year for the SEC, at the end of the quarter (March, June, September, and December). For large companies, these statements must be prepared within 40 days of quarter-end and its annual financial statements within 60 days of year-end.

D. **Who is responsible for the financial statements? Discuss the potential users of the Starbucks financial statements and the type of information they are likely interested in.**

A company's management has the responsibility of preparing the financial statements in regulation with the SEC. After that, the company's independent auditors are in charge of auditing these statements to make sure they are accurate.

The main potential users of the financial statements of Starbucks are management and outside shareholders, or others with a financial interest in the company. Management is interested in the statements to make sure that the business is being

efficiently financed, is doing well in its revenues and its performance ratios, and the information is accurate. Shareholders are interested in seeing if the company is doing well and what to do with their share in the company, depending on its financial position. Another group of users interested in the financial position of Starbucks would be its competitors.

E. Who are Starbucks' external auditors? Describe the two "opinion" letters that Starbucks received in 2013. In your own words, what do these opinions mean? Why are both opinions dated several months after Starbucks' year-end?

Starbucks' external auditor is Deloitte & Touche LLP, with the audit team located in Seattle, Washington.

The first opinion letter that Starbucks received talked about how Deloitte has reviewed and audited their consolidated financial statements. They performed their audit according to the PCAOB's standards and found that the statements present the financial information of Starbucks fairly and truthfully. The second opinion letter stated that Starbucks and its subsidiaries have maintained an effective Internal Control over Financial Reporting, according to Deloitte in accordance with the PCAOB. These letters are confirmation from an outside source that Starbucks is preparing their financial statements correctly and without fault.

Deloitte issued an unqualified opinion for Starbucks, meaning that their financial statements were in compliance with the standards of the PCAOB. The opinions are dated much later than year-end because it takes time for the external auditors to review all of the financial statements and make sure that they are correct and in accordance with the PCAOB.

F. Use a spreadsheet to construct common-size income statements (which Starbucks calls statements of earnings) and balance sheets for 2013 and 2012. Common-size income statements scale each income statement line item by total *net* revenues (sales). Common-size balance sheets are created by dividing each figure on a given year's balance sheet by that year's total assets, thereby creating a balance sheet on a "percent of assets" basis. You will use these common-size statements in answering several of the questions below. (Starbucks' investor relations website—investor.starbucks.com—contains a link to SEC filings. The company's Form 10-K can be found under annual filings and contains an Excel spreadsheet with financial statement data that may be helpful in creating the common-size statements).

Figure 7-1: Starbucks Consolidated Statement of Earnings

Consolidated Statements of Earnings (USD $)	12 Months Ended			
In Millions, except Per Share data, unless otherwise specified	Sep. 29, 2013		Sep. 30, 2012	
Net revenues:				
Company-operated stores	$11,793.20	79%	$10,534.50	79%
Licensed stores	1,360.50	9%	1,210.30	9%
CPG, foodservice and other	1,738.50	12%	1,554.70	12%
Total net revenues	14,892.20	100%	13,299.50	100%
Cost of sales including occupancy costs	6,382.30	43%	5,813.30	44%
Store operating expenses	4,286.10	29%	3,918.10	29%
Other operating expenses	457.2	3%	429.9	3%
Depreciation and amortization expenses	621.4	4%	550.3	4%
General and administrative expenses	937.9	6%	801.2	6%
Litigation charge	2,784.10	19%	0	0%
Total operating expenses	15,469	104%	11,512.80	87%
Gain on sale of properties	0	0%	0	0%
Income from equity investees	251.4	2%	210.7	2%
Operating income	-325.4	-2%	1,997.40	15%
Interest income and other, net	123.6	1%	94.4	1%
Interest expense	-28.1	0%	-32.7	0%
Earnings before income taxes	-229.9	-2%	2,059.10	15%
Income taxes	-238.7	-2%	674.4	5%
Net earnings including noncontrolling interests	8.8	0%	1,384.70	10%
Net earnings attributable to noncontrolling interest	0.5	0%	0.9	0%
Net earnings attributable to Starbucks	$8.30	0%	$1,383.80	10%
Earnings per share - basic	$0.01	0%	$1.83	0%
Earnings per share - diluted	$0.01	0%	$1.79	0%
Weighted average shares outstanding:				
Basic	749.3	5%	754.4	6%
Diluted	762.3	5%	773	6%
Cash dividends declared per share	$0.89	0%	$0.72	0%

Figure 7-2: Starbucks Consolidated Balance Sheet

Consolidated Balance Sheets (USD $) In Millions, unless otherwise specified	Sep. 29, 2013		Sep. 30, 2012	
Current assets:				
Cash and cash equivalents	$2,575.70	22%	$1,188.60	14%
Short-term investments	658.1	6%	848.4	10%
Accounts receivable, net	561.4	5%	485.9	6%
Inventories	1,111.20	10%	1,241.50	15%
Prepaid expenses and other current assets	287.7	2%	196.5	2%
Deferred income taxes, net	277.3	2%	238.7	3%
Total current assets	5,471.40	48%	4,199.60	51%
Long-term investments	58.3	1%	116	1%
Equity and cost investments	496.5	4%	459.9	6%
Property, plant and equipment, net	3,200.50	28%	2,658.90	32%
Deferred income taxes, net	967	8%	97.3	1%
Other assets	185.3	2%	144.7	2%
Other intangible assets	274.8	2%	143.7	2%
Goodwill	862.9	7%	399.1	5%
TOTAL ASSETS	11,516.70	100%	8,219.20	100%
Current liabilities:				
Accounts payable	491.7	4%	398.1	5%
Accrued litigation charge	2,784.10	24%	0	0%
Accrued liabilities	1,269.30	11%	1,133.80	14%
Insurance reserves	178.5	2%	167.7	2%
Deferred revenue	653.7	6%	510.2	6%
Total current liabilities	5,377.30	47%	2,209.80	27%
Long-term debt	1,299.40	11%	549.6	7%
Other long-term liabilities	357.7	3%	345.3	4%
Total liabilities	7,034.40	61%	3,104.70	38%
Shareholders' equity:				
Common stock ($0.001 par value) - authorized, 1,200.0 shares; issued and outstanding, 753.2 and 749.3 shares (includes 3.4 common stock units), respectively	0.8	0%	0.7	0%
Additional paid-in capital	282.1	2%	39.4	0%
Retained earnings	4,130.30	36%	5,046.20	61%

Consolidated Balance Sheets (USD $) In Millions, unless otherwise specified	Sep. 29, 2013		Sep. 30, 2012	
Accumulated other comprehensive income	67	1%	22.7	0%
Total shareholders' equity	4,480.20	39%	5,109	62%
Noncontrolling interests	2.1	0%	5.5	0%
Total equity	4,482.30	39%	5,114.50	62%
TOTAL LIABILITIES AND EQUITY	$11,516.70	100%	$8,219.20	100%

[1] In conjunction with the change in reportable operating segments, we reclassified goodwill by segment as of October 2, 2011.

G. Refer to Starbucks' balance sheet for fiscal 2013 (the year ended September 29, 2013).

i. Demonstrate that the accounting equation holds for Starbucks. Recall that the accounting equation is: Assets = Liabilities + Equity.

(in millions) 11516.70 = 7034.40 + 4482.30

ii. What are Starbucks' major assets? Calculate the proportion of short-term and long-term assets for 2013. Does this seem appropriate for a company such as Starbucks?

Starbucks' biggest assets are Cash and Cash Equivalents, Inventories, and Property, Plant, and Equipment.

Short-Term = 5741.40/11516.70 = 49.85%

Long-Term = (11516.70-5741.40)/11516.70 = 50.15%

This nearly half-and-half balance seems appropriate for a large company like Starbucks, where a lot of their assets are cash and inventory as well as property for storefronts.

iii. In general, what are intangible assets? What is goodwill? What specific intangible assets might Starbucks have?

Intangible assets are those that don't physically exist but are valuable because of the potential revenue that they create. Goodwill is the established reputation of a business regarded as a quantifiable asset, represented by the excess of the

price paid for a company over its fair market value. Some intangible assets that Starbucks may have are trade secrets, licensing agreements, contract-based patents, and copyrights.

iv. **How is Starbucks financed? What proportion of total financing comes from non-owners?**

Starbucks is financed mostly through debt, specifically Accrued Liabilities, Accrued Litigation Charges, and Long-Term Debt. This financing from non-owners ends up equaling approximately 61 percent of the total financing for the company.

H. **Refer to Starbucks' statement of earnings for fiscal 2013 (the year ended September 29, 2013) and to the common-size income statement you developed in part *f*, above.**

i. **Review the revenue recognition policies of Starbucks discussed in Note 1 (Summary of Significant Accounting Policies). Does Starbucks record revenue when they receive cash from their customers (cash-basis accounting) or do they follow a different rubric (for example, accrual accounting)? How does Starbucks record revenue on stored value cards (i.e., gift cards)? What challenges in measuring revenue do you observe? That is, are there any significant judgments management needs to make in recording sales revenues at Starbucks?**

Starbucks follows the method of accrual accounting. With stored value gift cards, revenues are recognized when these cards are redeemed. Until

then, it is considered unearned revenue. This poses a potential challenge where some gift cards might not end up being used, because the initial transaction has already taken place between Starbucks and the customer buying the stored value card. Fluctuations in unearned revenue will happen as a result of this policy. The bulk of this difference comes from the depreciation/amortization expense and litigation charge.

ii. What are Starbucks' major expenses?

Starbucks' major expenses include Cost of Sales and Store Operating Expenses. These make up 44 percent and 29 percent of total net revenues, respectively.

iii. Were there any significant changes in the cost structure during the most recent year?

The most significant change in the cost structure from 2012 to 2013 was the $2,784 million increase in Litigation Charges.

iv. In fiscal 2013, Starbucks separately reported a litigation charge and included it in operating income. Why didn't the company just include this amount within the line item for general and administrative expenses? Why is it an operating expense?

According to GAAP, any unusual litigation expense is required to be reported on its own as well as in the footnotes, so that those looking at the

financial statements have a better understanding where that expense came from. Since the amount of the litigation expense is significant and doesn't fall under any other expenses, it must be reported as an operating expense.

v. **Was the company profitable during 2013? During 2012? Explain your definition of "profitable."**

Profitability is best expressed with the profit margin percentage. In 2012, the profit margin was 10.4 percent. In 2013, the profit margin was 0.06 percent, which is a steep decline from 2012. Even without looking at the industry average profit margin, one can assume that Starbucks was profitable in 2012, but not 2013.

I. Refer to Starbucks' fiscal 2013 statement of cash flows.

i. **Compare Starbucks' net earnings to net cash provided by operating activities and explain the difference.**

Starbucks' net earnings in 2013 were $8.3 million, and their net cash provided by operating activities was $8.8 million. The difference between the two was $0.5 million. Net income (earnings) is the profit that a company has earned during a period of time, while net cash provided by operating activities measures the cash coming in and out from day-to-day operations of a business.

ii. **How much cash did Starbucks use for expenditures for property, plant and equipment during fiscal 2013?**

In 2013, Starbucks had $3,200.5 million invested in Property, Plant, and Equipment. This was an increase of $541.6 million from 2012.

iii. **What amount of dividends did Starbucks pay during the year? How does this amount compare to the amount of dividends declared as shown in the statement of equity?**

Starbucks paid $628.9 million worth of dividends. In 2013, they declared $668.6 million worth of cash dividends, a significant difference from what they actually paid. They may have declared some dividends for which the payment date had yet to occur by the time the financial statements were made. Also, they could have paid some cash dividends at the beginning of the fiscal year that had been declared in fiscal 2012. Therefore, the cash dividends paid will not always equal the cash dividends declared for a fiscal year.

J. **Several notes to the financial statements refer to the use of "estimates." Which accounts on Starbucks' balance sheet require estimates? List as many accounts as you can. Are any accounts estimate-free?**

The accounts on Starbucks' balance sheet that are estimates include:

- Inventory

- Litigation obligations
- Accounts Receivable
- Goodwill
- Intangible Assets
- Property, Plant, and Equipment

Accounts that may be estimate-free include

- Cash and cash equivalents
- Prepaid expenses

Case 8: BP p.l.c. - Contingencies

Executive Summary

This case deals with BP (British Petroleum) and the Deepwater Horizon Oil Spill in April 2010. This 200-million-gallon spill left BP with many contingent liabilities because of the deaths it caused and the following damage to the Gulf of Mexico. With GAAP, there are different ways to record these contingent liabilities on the financial statements depending on what information can be derived from the liability. After the oil spill, BP took responsibility for their actions and reported much of what they would likely end up owing people as both current and non-current liabilities on their financial statements. The main losses that BP would face post-oil spill would be lawsuits filed by businesses and individuals who faced losses directly as a result of Deepwater Horizon. BP ended up allotting $20 billion for compensation to businesses and workers affected negatively by the oil spill, though the total estimated damage was recorded at $40 billion. This case analyzes these contingent liabilities that BP faces as well as how they will deal with them.

In analyzing this case, I learned what real-world contingent losses look like. In classes, we have discussed contingent losses, but the reasonability and estimate of losses are always given to us in the problem. This differs from real life, because it is up to management and auditors of a company to decide if there will be a loss and estimate what that loss will be. In BP's case, it was obvious that they would face losses from lawsuits, but it was more difficult to determine the amount of this loss. When attempting to determine an amount, it is important to look at whether it is reasonable that a lawsuit is legitimate and stems directly from the actions of BP.

<u>Case Analysis</u>

A. **What is a contingent liability? Explain, in your own words, when a company would record a contingent liability (i.e. a contingent loss) on its books. List some types of contingent liabilities. Do companies ever record contingent assets (i.e. contingent gains)?**

   A contingent liability is a potential liability that depends on the outcome of some event taking place in the future. A company would record a contingent liability if the outcome causing it is likely to occur and the liability is able to be reasonably estimated. If both of these conditions are not met, the company can choose to disclose the contingent liability in their footnotes rather than the financial statement itself. Some examples of contingent liabilities include potential lawsuits, product warranties, and environmental contamination. Companies never measure and record contingent assets, because of the principle of conservatism in accounting. If anything, they will disclose the asset in their footnotes.

B. Product warranties are a common contingent liability. Consider a piece of equipment such as a telescopic joint, which BP purchases from GE Oil and Gas. The telescopic joint compensates for heave and offset on drilling vessels and is sold with a two-year warranty against defects. From BP's perspective as the purchaser of the telescopic joint, what is a product warranty? From the perspective of GE Oil and Gas, the manufacturer of the telescopic joint, what is a warranty?

From the perspective of BP, the product warranty would be an assurance type warranty. This warranty serves as an assurance from GE Oil and Gas that if something wrong happened with or because of their product, they would reimburse them for these damages. This warranty represents a contingent asset, which will be disclosed in the footnotes of BP's financial statements.

From the perspective of GE Oil and Gas, the warranty would be a contingent liability. This is due to the fact that if BP exercised the right to their warranty, GE would be liable to pay reimbursement for the damages. If GE finds that damage is probable and reasonable estimable, the recorded amount will most likely appear on their financial statements. The liability needs to be matched to the period of the sale.

C. What judgments does management need to make to account for contingent liabilities in general and accrued warranty costs in particular? How does a claim for damages resulting from the Deepwater Horizon oil spill differ from a warranty claim on a piece of equipment such as a telescopic joint?

For contingent liabilities in general, management needs to determine if both conditions will be met in order to record the liability on their financial statements. These conditions are if a loss is likely to occur and if this loss can be easily estimated. For accrued warranty costs in particular, management needs to be able to estimate what percentage of warranties will be exercised and how much of a loss they will face because of this.

A claim for damages from the Deepwater Horizon spill differs vastly from a warranty claim on a piece of equipment in that it’s harder to estimate the damages incurred from the event whereas damages on a product are more easily determined. The BP Oil Spill deals with tens of thousands of people and many different types of losses, such as property, business, or tourism. The amount of liability will depend on the situation and the loss that was incurred, whereas with a product it is generally a specified amount.

D.

i. **Describe some of the estimates that BP must make to account for the contingencies associated with the Deepwater Horizon oil spill. By way of comparison, the Exxon Valdez oil spill took place on March 24, 1989. Litigation continues as of early 2011.**

Presently, BP must attempt to estimate the contingent liabilities that they will be responsible for paying for following the Deepwater Horizon oil spill. The biggest liabilities that BP has dealt with since the spill and will deal with for years to come are lawsuits that businesses and individuals file against BP. BP already knows that they will face many lawsuits, and losses from those, but they must estimate a reasonable amount for them to record of their financial statements for years to come.

ii. **If you were the auditor for BP, how do you draw the boundary around the potential losses? Create a list of potential people that could sues, and talk about if you think it's reasonable if they sue (if they have a case)**

From the perspective of an auditor for BP, it would be difficult to determine where the potential losses begin and end. For businesses, most of these lawsuits stem from losses in their coastal industries, including fishing, charter boats, and tourism. For individuals, people filed suits for various reasons, such as property damage, health problems, and environmental damage stemming from the spill. On top of those suits, many BP

shareholders filed suit against the company. It is reasonable for businesses to sue for loss of profit if it can be directly traced that they lost out on this profit due to the BP oil spill. For individuals, it is reasonable depending on what they are suing for. If their health problems occurred right after the oil spill with symptoms that came from that kind of environment, they have a legitimate case. If the individual seems to be making a stretch in order to get some money from BP, their claim will not be as reasonable. Shareholders suing would be pretty unreasonable, given that they know the risk when purchasing stock. It's not necessarily reasonable that BP would have to pay out to their shareholders for their stock losing value, because they same would not happen if the stock lost value given different circumstances.

Case 9: The Wendy's Company – Equity Method Investments

Executive Summary

This case looks at the relationship of an investor company with an investee company. It uses a real-life example, Wendy's, who owns 50 percent of Tim Horton's. Companies acquire and hold on to other companies' stock in order to leverage significant influence over the investee company. This is to increase their assets as well as often venturing into new markets without having to deal with barriers to entry because they are acquiring a brand or company that has already done that. In this case, these companies are different in so many ways, but similar in so many others. Wendy's is an American company, the third largest hamburger fast food chain in the world, known for their square-shaped burger patties and their Frosties. Tim Horton's is Canada's largest quick service restaurant chain, specializing in donuts and coffee. This case primarily looks at the financial statements of these companies, as well as how to get to the numbers shown on the statements and how to analyze them.

In preparing this case, I learned a lot more about how parent companies and subsidiaries work as well as owning a significant portion of a company's stock in general. In intermediate accounting, we had an entire chapter that went over investments and the different methods used to measure the investment based on how much stake one owns in the investee's company. It was way more interesting getting to see how it actually looks in the financial statements and footnotes rather than just having the numbers presented in the form of a problem. Through this case, I learned how to apply those skills that I learned in the classroom to look at something that a real auditor would and reconcile how those numbers got to be there and if they are correct.

Case Analysis

A. In general, why do companies enter into joint-venture agreements?

Companies enter into joint-venture agreements for a variety of reasons. The companies involved can pool their knowledge, human capital, and other resources in order to make the contracted project more profitable than either company could on their own. The risk of committing to a project is shared between companies, so if they were to face a loss, they wouldn't take the entire blunt of it. On top of this, a joint-venture enables companies to have more flexibility because they are not permanently bound to the other company, unlike a merger or acquisition.

B. Consistent with U.S. GAAP, Wendy's uses the equity method to account for its joint venture in TimWen. Briefly explain this accounting method. In your answer, be sure to comment on how the investing company accounts for its initial investment and any subsequent income and dividend activity of its investee.

In U.S. GAAP, the equity method is a technique that a company uses when assessing their profits from an investment in another company. This method is used when the investing company owns more than 20 percent of the other company's stock, which is considered significant control. At the initial investment, the company records their investment at cost, with periodic adjustments depending on the investee company's income or losses. The company adjusts their investment value based on their share in the investee company. So, if a company has 30 percent stake in a company and the company reports $2 million in net income, the investor

company reports $600,000 under the equity method. But if the investee company faces a $100,000 loss one year, the investor company reports a $30,000 loss.

C. When a company purchases shares (ownership) in another company, the investment amount may exceed their share of the book value of the underlying net assets of the investee. How does the investing company account for this excess amount under the equity method?

Prior to being invested in, the investee company has already been amortizing and depreciating their assets on the books. Once the investor invests their money into the investee, the depreciated assets must be written up on the investee's books to represent the fair value that the investor paid for the assets. This is done by receiving fair value appraisals from a third party. When an investing company pays more for their ownership in an investee company than the sum of the book value of the assets, the difference in these two numbers is attributed to goodwill.

D. Consider the information in Note 8. What amount did Wendy's include on its 2012 and 2011 balance sheets for their equity method investments? Where does this appear on Wendy's consolidated balance sheet?

Note 8 is the only place to find Wendy's Inc's investment amounts split between their investments using the equity method and the cost method. On the balance sheet, Wendy's included $91,819 for its 2011 equity investments and $87,620 for its 2012 equity investments, including Tim Horton's and a project in Japan. On Wendy's consolidated balance sheet, this appears under investments but is

combined with Wendy's Inc's cost investments as well; note 8 is the only place to find the values on their own.

E. Using information in Note 8, compare the amount recorded for Wendy's investment in TimWen at December 30, 2012 with Wendy's 50 percent share of TimWen's equity at December 30, 2012. What accounts for the difference between these two amounts?

At December 30, 2012, Wendy's investment in TimWen is $89,370. At this same time, TimWen's equity (assets minus liabilities) is $70,565. If Wendy's owns 50 percent of TimWen's stock, that means that $35,283 is owned by Wendy's. Those numbers are extremely far off from each other, meaning that either Tim Horton's had an extremely poor year or there was a mistake in calculating one or the other values.

F. Consider the information disclosed in Note 8 regarding Wendy's investment in the TimWen Joint Venture.

a. How did Wendy's equity method investment in TimWen affect their earnings before taxes in 2012 and 2011? Where does this appear in Wendy's consolidated statements of operations?

For Wendy's, their investment in TimWen increased their earnings before taxes both in 2011 and 2012. Using the equity method, their earnings were adjusted for amortization from the acquisition price. In 2011, Wendy's earnings before taxes were $10,571 and in 2012, their earnings before taxes were $10,551. This appears

on Wendy's consolidated statement of operations under "other operating expenses".

b. **Prepare the journal entry to record Wendy's share of TimWen's 2012 earnings.**

Equity Income	13,680	
Investment Income		13,680

c. **What is the amount of the amortization of the purchase price adjustments in 2012? Prepare the journal entry to record the amortization of the purchase price adjustments for 2012.**

Equity Income	3,129	
Equity Investments		3,129

d. **What amount of dividends did Wendy's receive from the TimWen joint venture in 2012 and 2011? Prepare the journal entry to record the receipt of dividends from TimWen for 2012.**

Cash	15,274	
Equity Investments		15,274

G. Consider the information in the statement of cash flows.

a. The operating activities section of the statement of cash flows reports a negative adjustment for "Equity in earnings in joint ventures, net" of $8,724 in 2012. Reconcile this amount to the information disclosed in Note 8. Explain why a negative adjustment is made to arrive at net cash from operating activities.

A negative adjustment is made to arrive at net cash from operating activities because the inflow relates to the investing activity of the firm. When the earnings were first realized, they were included as a part of net income. Because this was a non-cash transaction, the value should be subtracted from net income in preparation of the cash flow statement in order to arrive at net cash from operating activities.

b. The operating section also reports a positive adjustment for "Distributions received from joint venture" of $15,274 in 2012. Reconcile this amount to the information disclosed in Note 8. Explain why a positive adjustment is made to arrive at net cash from operating activities.

This amount represents the dividends that were distributed from Tim Horton's to Wendy's in 2012. A positive adjustment is made because the distributed dividends are reconciled to cash, so they serve as an addition to net cash provided by operating activities.

Case 10: Johnson & Johnson – Retirement Obligations

Executive Summary

Pension plans are used by many companies, providing benefits in the future that employees probably wouldn’t save on their own. Because these are benefits that employees won’t receive until after their retirement, employers pay off this obligation a certain amount every year that the employee works for them. This case analyzes the pension plan of Johnson & Johnson, as well as each component that goes into calculating their pension expense and their retirement plan assets.

In completing this case, I learned more about pension plans, including the different types, how to compute pension expense, retirement plan obligations, and retirement plan assets. This case was assigned the same week that we studied the pensions chapter in intermediate accounting, so it made it much easier to understand pensions with a comprehensive real-world example. It’s interesting to see how the numbers that I calculate in accounting problems fit into the greater financial statements of a company.

Case Analysis

A. There are two general types of retirement (i.e. pension) plans—defined benefit plans and defined contribution plans.

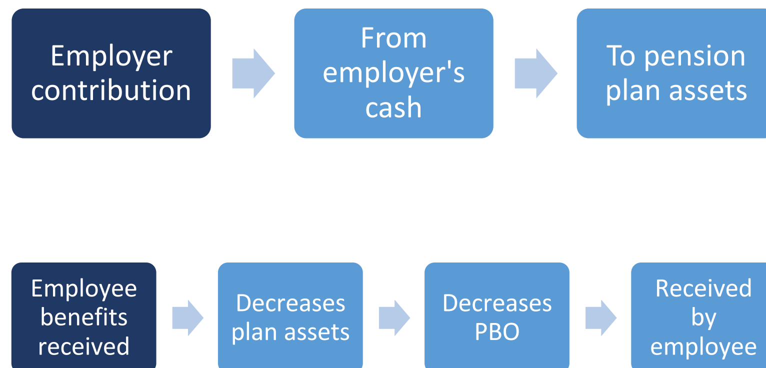
i. How do these two types of plans differ? Which type does Johnson & Johnson have?

Defined contribution plans are pension plans that are primarily funded by the employee, with the employer matching contributions until a certain cap. The most common type of defined contribution plan is a 401(k). The formula for figuring out how much an employer owes is very simple. Defined benefit plans guarantee an employee a specific amount of benefits at their retirement, and the obligation to provide these benefits is borne entirely by the employer. The formula of contribution is more complex, due to the assumptions that actuaries must make to determine the amount that needs to be in the pension plan by the employee's retirement.

ii. Explain why retirement plan obligations are liabilities.

Retirement plan obligations are considered liabilities because they are future obligations to pay a defined amount for employees' current service. Pension plans are considered part of an employee's compensation, so the employer has an obligation to pay the employee the retirement plan amounts.

Figure 10-1: Retirement plan flow chart



iii. List some of the assumptions that are necessary in order to account for retirement plan obligations.

To account for retirement plan obligations, actuaries must make assumptions on information like how long an employee is going to work for their company, when the employee will retire, and how many years they have between retirement and death.

B. In general, companies' pension obligations are influenced each year by four main types of activities: service cost, interest cost, actuarial gains or losses, and benefits paid to retirees. Explain each of the four activities in your own words.

- Service cost is the present value of the projected retirement benefits earned by employees in the current period. This is the amount that the employer sets aside to cover the retirement benefits accrued by employees.

- Interest cost is the interest accumulated on the part of the projected benefit obligation that is not already paid off. Since pensions are a deferred compensation, the employer incurs a liability until the entirety of the pension plan is paid off, which is recorded at a discounted rate.
- Actuarial gains or losses show the changes in the employer's projected obligation and the market impact on the employer's plan assets. Often times, gains and losses come from a change in actuarial assumptions.
- Benefits paid to retirees are defined within their name. When an employer pays out benefits, this decreases plan assets and increases cash paid.

C. In general, companies' pension assets are influenced each year by three main types of activities: actual return on pension investments, company contributions to the plan, and benefits paid to retirees. Explain each of the three items in your own words.

- Actual return on pension investments is the current year's earnings on invested plan assets, such as stocks, bonds, and other investment instruments. This amount offsets the pension expense incurred by the employer.
- Company contributions to the pension plan are amounts that the employer invests into plan assets, decreasing their pension obligation.
- Benefits paid to retirees are distributions to those employees that are now retired and reaping the benefits of their pension plans.

D. In general, companies' pension expense and pension plan assets both have a "return on plan assets" component. How do the two returns differ? Explain the rationale for this difference.

For a company's pension expense, the "return on plan assets" component is the expected return on plan assets. This estimate is an assumption that a company can tweak if needed; the company uses this to reduce market-induced volatility in the income statement. When finding the fair value of plan assets, the "return on plan assets" component is the actual return on plan assets. This can help a company track any increases or decreases in the pension's rate of return.

E. Johnson & Johnson provides other benefits to retirees including healthcare and insurance benefits. What is the primary difference between the company's other benefits plans and its retirement plans?

While pension plan benefits are based on different variables, such as an employee's years of service or compensation, healthcare and insurance benefits are the same for all employees. Also, healthcare and insurance benefits are not funded in advance and are able to be modified at any time.

F. Consider Johnson & Johnson's pension expense detailed on page 61 of the company's annual report.

Note that the company uses the term "net periodic benefit cost" to refer to pension expense.

i. How much pension expense did Johnson & Johnson report on its 2007 income statement?

Johnson & Johnson reported $646 million on its 2007 income statement.

ii. Prepare the journal entry to record the service cost and interest cost portion of the 2007 pension expense. (Journal entries in millions)

Account	Debit	Credit
Pension Expense	1,253	
Projected Benefit Obligation – Service Cost		597
Projected Benefit Obligation – Interest Cost		656

G. Consider Johnson & Johnson's retirement plan obligation, that is, the pension liability, as detailed on page 62 of the company's annual report.

i. What is the value at December 31, 2007, of the company's retirement plan obligation? What does this value represent? How reliable is this number?

As of December 31, 2007, the value of the company's retirement plan obligation is $12,002 million. This value represents the amount of benefits

the company is obligated to pay out to its employees. This number is fairly reliable, because it takes into account the actuarial assumptions; however, this can change based on a change in those actuarial assumptions.

ii. **What is the pension-related interest cost for the year? Compute the average interest rate the company must have used to calculate interest cost during 2007. Does this rate seem reasonable? Explain.**

For 2007, the interest cost is $656 million. Johnson & Johnson used an average interest rate of 5.63 percent to get to this number. To figure out if this rate is reasonable, Johnson & Johnson would need to look at the interest rates of similar retirement plan obligations and compare. This falls within the domestic and international rates disclosed in the footnotes

iii. **What amount of pension benefits were paid to retirees during the year? Did Johnson and Johnson pay cash for these benefits? How do the benefits paid affect the retirement plan obligation and the retirement plan assets?**

During the year, Johnson & Johnson paid out pension benefits of $481 million. These benefits were not paid with cash, but instead with previous contributions to plan assets. This decreases both the retirement plan obligation and the retirement plan assets, because the assets were used to pay off the obligation.

H. Consider Johnson & Johnson' retirement plan assets that is, the pension plan asset, as detailed on page 62 of the company's annual report.

i. What is the value at December 31, 2007, of the retirement plan assets held by Johnson & Johnson's retirement plan? What "value" is this?

On December 31, 2007, the value of Johnson & Johnson's retirement plan assets is $10,469 million. This is the fair value of the assets, including both the investments and the contributions that were made during the year.

ii. Compare the amount of the expected return on plan assets to the amount of the actual return during 2006 and 2007. Are these differences significant? In your opinion, which return better reflects the economics of the company's pension expense?

The expected returns for 2006 and 2007 were $701 million and $809 million, respectively. The actual return in 2006 was $966 million, and the actual return for 2007 was $743 million. In 2007, there was only an 8 percent difference between the expected and actual return, but there was a 27 percent difference between the expected and actual returns in 2006, which is much more significant. This difference may have had an effect on how Johnson & Johnson accounted for the expected return in 2007, making a much more accurate prediction for the actual return. Because of this, the expected return better reflects the economics of the company's pension expense.

iii. How much did Johnson & Johnson and their employees contribute to the retirement plan during 2007? How does that compare to contributions in 2006? (See page 63.)

During 2007, Johnson & Johnson contributed $317 million to the retirement plan assets, and their employees contributed $62 million. During 2006, the company contributed $259 million, while the employees contributed $47 million. There was an increase in both employer and employee contributions to the retirement plan assets.

iv. What types of investments are in Johnson & Johnson's retirement plan assets?

In the U.S., Johnson & Johnson's retirement plan assets consist of 79 percent equity securities and 21 percent debt securities. Internationally, Johnson & Johnson's retirement plan assets consist of 67 percent equity securities, 32 percent debt securities, and 1 percent real estate and other investments.

I. Is the company's retirement plan under funded or over funded at December 31, 2007? At December 31, 2006? Where does this funded status appear on the balance sheet?

In 2007, Johnson & Johnson's retirement plan is underfunded by $1,533 million, while in 2006, the plan is underfunded by $2,122 million. In both cases, this funded status appears in multiple places on the balance sheet – non-current assets,

current liabilities, and non-current liabilities. The amount under each of these components can be found under Note 13 of the financial statements.

Case 11: On the Balance Sheet-Based Model of Financial Reporting

Executive Summary

FASB is currently considering if they need to be doing something different with their conceptual framework; the main reason for this is because of the desire to converge their standards with IASB's, so there is a more uniform accounting standard globally. It is important for FASB and IASB not to just be uniform, though, they must also be adopting the "correct" way to go about financial reporting. For the last thirty years, FASB has used balance sheet-based modeling for all of its financial reporting. There are some reasons that argue why this might not be the best way to do this. While it is an adequate system, this article argues that there are some issues with this standard.

Before discussing the problems with the balance sheet-centric standard, the background of how FASB got to this point is important to note. The gist of the balance sheet-based model is that the most important goals of financial reporting are determining assets and liabilities, with all other variables considered secondary to these. Because of this, amounts, especially earnings, on the income statement are reported based on the numbers from the balance sheet. On the flip side, the income statement-based approach is essentially the opposite of the balance sheet. For this approach, the primary goals of financial reporting are revenues and expenses, as well as the timing and magnitude of these amounts. Balance sheet values are considered derivative to the incomes statement. This follows the principle of revenue recognition and the matching of expenses to revenues. Historically, this was the primary view of financial reporting up until the mid-1970s, with the beginning of FASB as the official standard setter. They came to the conclusion that the balance sheet approach is the most logical and straightforward approach to accounting, and so it became the standard for financial reporting. Since then,

they have expanded on this notion and improved upon the balance sheet approach as much as they can, but in doing so, have only made it more complicated.

The first issue this article has with the balance sheet-based model is that this standard does not represent what accounting is supposed to go off of, which is the reflection of business reality. Most firms use the income-statement approach to accounting, but they have to go against what is natural and makes the most sense in order to appease FASB and abide by GAAP. Businesses are set up to incur expenses in order to earn revenues, but the balance sheet approach does not reflect the flow of how businesses are conducted. The balance sheet approach makes it appear that businesses are "asset greenhouses", storing their assets only to grow them; in reality, businesses are "asset furnaces", where assets are transformed in order to create new, larger revenues. The way that firms operate makes sense for them to prioritize revenues and expenses, and in turn make assets a secondary role in this, which aligns entirely with the income statement approach. Even the most important users of businesses' financial information, investors, look at and base their decisions off of information that comes directly from the income statement.

The second issue is that assets are not as clear a concept as income, so the financial reports should be based around income rather than assets. Economically, the concepts of assets and income are entirely connected; if one has an asset, there is going to be a stream of income linked to it, otherwise it would not be an asset. According to the balance sheet approach, FASB is inferring that these two concepts can be separated, and one can be considered more important than the other. Even with the addition of the more

complicated intangible assets, that make it even clearer that income comes directly as a result of assets.

The third issue deals with the concept of earnings. Earnings are arguably the most important part to come out of financial reports but have become more complicated and less useful with the evolution of financial reporting. The majority of these complications come from the seemingly constant revaluations of assets, making it harder to understand earnings on the balance sheet. Investors and analysts consider earnings to be the single most important amount that can be reported in a financial statement, but the balance sheet approach is making it much more complicated to come to a clear, conclusive number. The balance sheet approach views earnings as a "change in net assets", reducing it to a wildly unpredictable value. Thus, the balance sheet essentially creates earnings rather than calculating the value of earnings in a way other than by means of deduction.

The final major issue with this standard is that it's causing accountants to have to make more and more estimates of value and incorporate these into their financial reports, making it more difficult to bridge the gap between financial markets and the "real economy". In practice, the balance sheet approach is incredibly difficult to implement in practice with actual financial statements. Fair value accounting puts too much faith in the notion that the market prices are the standard of correctness, rather than using their fundamental values. There is a difference that needs to be recognized between the real economy, where real values lie, and the financial market, where prices are given based on educated guesses. This can end up having large consequences, when further down the line the two values are wildly different.

This article poses two suggestions for improvements to current financial reporting. The first is making a clear distinction between operating and financing activities on their financial statements; this will make it much more understandable to those analyzing the statements for cash flows. Operating activities support and enhance the activities and events that occur within the firm itself and do not provide value outside of the company; an example of an operating asset is property, plant, and equipment. Financing activities include cash and cash equivalents, which are assets whose values are independent of the firm itself. This would cause financial statements to have more than one bottom line, with a clear distinction between the two. The other improvement would be for the operating activities, to make sure that the primary emphasis is the matching of expenses to revenues. Most firms are managed using the income statement approach, so accounting needs to reflect this reality. The two main functions of income statement accounting are the matching principle and the revenue recognition principle. Because of this, there needs to be an emphasis and refocus back onto these important pillars of accounting.

Questions

How did reading this article change your current way of thinking?

This article changed my way of thinking in that it opened my eyes to the idea that there are multiple ways to go about financial reporting. In accounting classes, we are taught what methods and steps are used by FASB in order to abide by GAAP, therefore my current thoughts on this concept were all formed by what was told to me beforehand. The information given in this article had a unique effect on my thinking, because it used information that I have already learned while presenting it in a new perspective.

It's really interesting to have another perspective thrown into the mix and being told "everything you know about accounting might not have to be as complicated as it is", because I would love to have a simpler way to go about some of the processes we go about as accountants. Reading this article, the author made a very clear argument about why they should at least consider a change in the way that financial reporting is done. I agree the most with the first point that businesses use income statements to come to most of their conclusions anyways, so there is no reason why they should not be allowed to complete their financial reporting as well. It seems unnecessarily complicated that companies should have to go out of their way to make their financial reports on something that doesn't even pertain to investors and analysts as much as their initial conclusions.

Another thing that this article changed my perspective on was the idea on the complications of financial reporting. Before reading this article, my understanding was

just that financial reports were based off of some sort of combination of all the financial statements. It turns out that there's multiple ways to go about this, and each of them has to do with being based on a specific financial statement. This means that financial reports technically could differ even when presented with the same upfront information, which doesn't make much sense. Though I already knew that accounting could be complicated, with different methods for measuring and such, this just added a new layer to discrepancies in it.

This doesn't necessarily go along with what the topic is on itself, but I think it just changed my perspective on FASB in general. FASB always seems like this all-knowing entity, and so it is surprising to me to read about them possibly doing something wrong. The article's argument made a lot of sense to me, but I also have to assume that FASB has reasons behind why they use the balance sheet-based method rather than the income statement-based method. Considering that FASB is the group in charge of setting accounting standards, they wouldn't go with one method if they didn't have any logic to back it up. One thing I wish that this article had cleared up more was the counterargument advocating for the balance sheet-based method. The best persuasive arguments make sure to give reasons why the other argument/perspective could be used, which this article skirted around.

How will you use this information in your future career? Be thoughtful and creative about the situations you will encounter where this article will affect your beliefs and the way you carry out your future job.

In my future career, the information given in the article will prove useful when understanding and analyzing financial information. Even though FASB currently abides by a balance sheet-based method of financial reporting, it's important to keep in mind information taken from the income statement as well. The main reason for this is because the most important thing for firms to think about is the well-being of the investors, and the information most important to the investors comes from the income statement. Earnings are the number one priority for investors, and the balance sheet doesn't reflect this information in the same regard as the income statement does. While this would be much easier to do if FASB adopted an income statement-based method of financial reporting, it's still definitely possibly with either method.

Another way that I will use the thinking from this article in my future career is attempting to bridge the gap between financial markets and the "real economy" as best as I could. The most tangible way to go about this would be to elect against using the fair value method when given the option. This is because the article talks about how this method puts too much faith in how the markets are measuring the worth of something and not what it actually may be worth. This is something to definitely keep in mind when deciding how to measure the value of an asset.

Case 12: Google Inc. – Earnings Announcements and Information Environment

Executive Summary

When creating financial statements, companies want to make themselves look their best as to impress and attract investors, as well as reflect their real numbers and abide by the standards set by FASB. Sometimes, the GAAP numbers aren't the most reflective on what these companies want to convey to investors, if that is the inclusion of certain expenses. A way for companies to keep their financial statements honest, attractive, and in line with what is legally required of them, they can include both GAAP earnings and well as reconciling this number to record non-GAAP earnings too. Regulation G defines this number as "representing a company's historical or future financial performance, financial position, or cash flows that excludes amounts otherwise included in – or excluded from – the most directly comparable U.S. GAAP measure". This does not break any rules because these companies are still abiding by GAAP but want to show their investors numbers that they think better reflect their earnings for that period.

Google does this in their financial statements, including that of the fourth quarter of 2013, which is what is analyzed for this case. Some expenses that Google eliminated for their non-GAAP net income were stock-based compensation, restructuring, net losses from discontinued operations, and the income tax effects related to these expenses.

In this case, I learned that companies reconcile their net income to record both the U.S. GAAP amount as well as a non-GAAP amount. This is important to know because it has become common for companies to include both numbers in their financial statements, recently being as many as 60 percent of IPOs the last few years. Ever since the SEC

issued Regulation G in January 2003, the focus has shifted from pro forma financial information to non-GAAP financial measures. I would have been really confused why Google included this non-GAAP amount had I not researched how companies treated these measures before reading. Many companies present these numbers because they believe that it shows investors a better view of their company, rather than the “one size fits all” method that is GAAP.

Case Analysis

H. Read the excerpts of the press release titled "Google Announces Fourth Quarter and Fiscal Year 2013 Results" and review Google's operating performance reported in the statements of income accompanying the press release.

I. The press release includes information about non-GAAP financial measures for the fourth quarter of 2013. Consider the table that reconciles GAAP measures to the non-GAAP measures. What explains the difference between GAAP net income and the non-GAAP equivalent? Do you agree with each of Google's adjustments in computing non-GAAP earnings? Why or why not?

The GAAP net income was recorded at $3,376, while the non-GAAP net income was measured at $4,096. The difference between GAAP net income and the non-GAAP equivalent is explained with the inclusion of adjustments, including the elimination of stock-based compensation expenses, restructuring and related charges, and the related income tax effects with those expenses. Also, the non-GAAP net income includes the elimination of net losses from discontinued operations. I don't necessarily agree with Google's adjustments to calculate non-GAAP earnings, but I understand why they would. While they do need to abide by GAAP, "such prominent measures have since become a prominent part of the performance narratives of more and more U.S. and foreign companies", so

it is important to make their numbers more easily comparable to those of other similar companies.

I. Use the attached stock-market charts for Google for the period January 1, 2013, through February 14, 2014, to answer the following questions.

I. **Compare Google's fiscal 2013 earnings performance with the movement in Google's stock price over 2013.**

Over 2013, Google's stock price steadily increased, starting its lowest in January and ending its highest in December. Google's fiscal 2013 earnings performance moved in line with its stock price, because there was a steady increase in net income at the end of 2013 versus the net income at the end of 2012.

II. **Compare Google's 2013 stock price performance with the performance of the broader set of firms trading on the NASDAQ exchange (that is, the NASDAQ index).**

Google's stock price moved fairly similarly to the NASDAQ index's. While Google consistently had a higher performance, it moved up when the index moved up and moved down when the index moved down.

III. Based on the stock market chart, did the market perceive the earnings news in Google's press release dated January 30, 2014, as "good news" or "bad news"? *Note*: the press release was made available after the close of trading for the day.

Based on the stock market chart, the market perceived Google's press release about their earnings as "good news". The stock price attained a small spike in its price after the fourth quarter earnings were released, giving Google a good financial start to 2014.

J. Read the *Wall Street Journal* article from January 30, 2014 titled "Google Reports Higher Profit."

I. According to the article, how did Google's fourth quarter revenue and earnings compare to the consensus analyst forecasts at the time of the earnings press release? Are these relations consistent with the positive stock market reaction following the press release?

According to the article, Google earned revenues of $16.9 billion for the quarter, and analysts had projected them to earn $16.8 billion Google's fourth quarter revenue and earnings were fairly similar, but exceeded, the amount that analysts had forecasted for the period. This aligns with the positive stock market reaction that initially followed the press release.

II. What other factors does the article discuss that might contribute to the market's positive reaction to the earnings press release? Are there any factors that might cause investors to be concerned about Google's recent performance?

There are numerous other factors that might contribute to the market's positive reaction to the earnings press release. One major factor would be the sale of their Motorola smart phone unit, which was extremely unprofitable. Another factor could be major increase in advertising revenue, stemming from a 31 percent increase in click's on Google's search advertisements. Another factor is the fact that Google has been working really hard to make their products and service more user-friendly on mobile devices as well as computers. These are a few of the factors that went into Google's successful press release and the market's very positive reaction to it.

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