Financial Reporting Principles and Accounting Concepts: A Collection of Case Studies

Caroline McLeod

Financial Reporting Principles and Accounting Concepts: A Collection of Case Studies

By
Caroline Mae McLeod

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

Oxford
May 2020

Approved by:

Victoria Dickinson

Advisor: Dr. Victoria Dickinson

W. Mark Wilder

Reader: Dr. W. Mark Wilder

ACKNOWLEDGEMENTS

First and foremost, thank you to my parents have supported me in every endeavor. Thank you to my friends and family who have encouraged me throughout my life. To my teachers and mentors at Heritage High School, thank you for instilling in me a love for learning. Thank you to the Patterson School of Accountancy and all my professors, especially Dr. Victoria Dickinson, for creating an academic environment that builds passion and drives success. And lastly, to the Sally McDonnell Barksdale Honors College staff and generous supporters, thank you for enriching my undergraduate experience at the University of Mississippi.

ABSTRACT

CAROLINE MAE MCLEOD: Financial Reporting Principles and Accounting Concepts: A Collection of Case Studies
(Under the Direction of Victoria Dickinson)

The following thesis is a collection of solutions to case studies related to various financial accounting and reporting standards in agreement with Generally Accepted Accounting Principles as set forth by the Financial Accounting Standards Board. In alignment with the topics learned in Intermediate Financial Accounting, each case focuses on a unique area of financial reporting along with application relevant to real world companies. The thesis demonstrates an understanding of accounting principles, financial statement preparation and analysis, and current accountancy topics. The case studies were completed under the direction of Dr. Victoria Dickinson in fulfillment of the requirements for the University of Mississippi, Sally McDonnell Barksdale Honors College, and Patterson School of Accountancy ACCY 420 course in the 2018-2019 academic year.

TABLE OF CONTENTS

IBM Watson

Data Analytics Case

Prepared By: Caroline McLeod

August 29th, 2018

Table of Contents

1.1 Case Introduction

The world of accounting is constantly changing and developing. One key advancement is the use of data analytic tools, specifically in the audit and tax fields. These tools have a wide variety of capabilities, some of which might be more useful in certain fields or for certain firms than others. Not only can data analytics provide more information more accurately than ever before, but also allows accounting professionals to expand the scope of their work due to the speed and efficiency that comes from using these tools. This case explores the varying capabilities of these tools in order to make an informed decision regarding their practicality in a business setting.

IBM has always been on the forefront of technology development and their data analytic giant, Watson, is no different. After analyzing Watson's history, capabilities, and real-world applications I now have a deeper understanding of the true impact that a data analytics tool can have on a firm and their engagements. My research demonstrated the extensive scope of data analytics specific to the field of accounting and beyond the obvious applications. I also learned about the process of investing in a tool like IBM Watson and the impact that such a decision could have on a firm's staff and clients.

1.2 Purpose of Tool

"Identify the purpose of IBM Watson and how it is used to make business decision."

a. IBM's Watson is supercomputer originally developed to answer questions on Jeopardy but has become so much more. This data analytics processor combines a sophisticated analytical software with artificial intelligence (AI) that has applications for a wide range of business processes. Watson can evaluate and analyze almost any kind of data from any source, unstructured and structured alike. The AI component allows Watson to constantly learn as it interacts with users and data, as well as process and respond in natural language as opposed to complicated code. When it comes to making business decisions, more information is always better. However, an information overload can be overwhelming and cause a delay in decisions. This is where Watson comes in; personnel can focus on the questions and answers needed to make the tough choices while Watson analyzes all relevant data and answers those questions. This capability can challenge professionals to seek out never asked questions and expand their potential.

1.3 Business Setting

"How, specifically, would you use the tool in the following business settings? Create at least three specific scenarios for each category in which the tool would lead to more efficiency and/or better effectiveness. Be sure to describe what kinds of data your tool would use for each scenario."

a. Auditing

i. While conducting an audit, it is crucial to examine relevant transactions for a variety of criteria. With Watson's information retrieval abilities, it could quickly search ledgers, documents, and statements for materiality, categorical descriptions, or containing a particular phrase like 'per controller.' This would also expand the scope of Journal Entry testing and make the entire process more efficient and accurate.

ii. Another audit capability would be an Unrecorded Liability search. Watson would scan invoices and entries for correctly accrued transactions based on a period/year end date. An adjustment to the trial balance can be easily made after this information is obtained.

iii. Watson is also capable of elaborate trend analysis by instantly searching for fluctuations and outliers. This would be extremely beneficial with regards to revenue and expense testing, exposing month end JE outliers, and ensuring consistency from month to month. Often times it is difficult to analyze trends for cyclical business, but Watson could adjust to track by season or cycle. With recurring engagements, Watson learns and remembers as it works and would be able to store all relevant findings from prior years as a benchmark for future audits.

iv. Watson could also aid in risk assessment by checking information against a company's internal controls. Simply scanning documents for signatures and approvals or making sure authorized transactions and entered transactions are matched. Prediction and suggestion powers offer potential for aiding auditors in their risk calculation for an engagement.

v. Finally, Watson would be able to quickly and accurately select samples either randomized or on specific criteria. For example, in a 401k audit it is necessary to collect a participant census and select for newly hired, newly terminated, and highly compensated employees. Watson could instantaneously choose a random sample that meets this criterion and even go so far as to perform the tests that an auditor needs.

b. Tax Planning

i. Another notable feature of Watson when it comes to tax planning is data extraction, specifically related to tax credits. With extreme accuracy, Watson can find specific data related to any number of tax codes within a set a document. This ensures all appropriate credits are being accounted for and used properly.

ii. Watson can also instantly access the most updated version of tax codes and tax preparers can conveniently search for any relevant information they may need while preparing or filing.

iii. Finally, Watson can be used to test how different actions will affect taxable income and predict changes to future earnings. Using a combination of data from statements and returns, Watson can search and suggest strategic moves and a number of possible outcomes. This connection of statements to returns is already being used by H&R block to augment their preparers and maximize returns while reducing risk.

1.4 Memo to Partners

"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 KPMG

From: Caroline McLeod

Date: 8/29/2018

Subject: IBM Watson Research

IBM Watson is an incredibly powerful tool that could benefit our firm in a variety of ways not limited to but including data extraction, prediction, trend analysis, and suggestion with regards to audit and tax planning. This surprisingly affordable tool would offer not only a wealth of information from its large network of servers and databases but can also process virtually any type of data that we employ. A major benefit to investing in Watson is becoming a part of the IBM network. IBM is very willing to work with their clients and ensure that Watson meets our needs as well as developing specific tools enabled to work with Watson and impact our business in whatever way we see fit. This system also requires very little training or technical knowledge and would be a great way to introduce our team to the world of AI and the possibilities it contains.

Not only will Watson increase our efficiency and accuracy as a firm but could also expand the scope of our services. As our professionals explore the capabilities of Watson we can find new ways to improve our client's experience and provide solutions to problems we may have been ignorant to in the past. The Watson system is ideal because its purpose is to increase collaboration between humans and systems. It is not a replacement for our professionals, but rather an augmentation to their skills and expertise. Watson can learn and grow with our firm and is not only an investment for today, but also an investment in our future.

Sincerely,

Caroline McLeod

1.5 Sources

Arrowsmith, Ranica. "KPMG Offers New IBM Watson-Enabled Accounting Tools." *Accounting Today*, 15 Mar. 2018, www.accountingtoday.com/news/kpmg-offers-new-ibm-watson-enabled-accounting-tools.

Burns, Ed. "What Is IBM Watson Supercomputer?" *SearchEnterpriseAI*, June 2018, searchenterpriseai.techtarget.com/definition/IBM-Watson-supercomputer.

Stimpson, Jeff. "Block Applies IBM's Watson to Tax Prep." *Accounting Today*, 3 Feb. 2017, www.accountingtoday.com/news/block-applies-ibms-watson-to-tax-prep.

Rocky Mountain Chocolate Factory

Financial Reporting Case

Prepared By: Caroline McLeod

September 5th, 2018

Table of Contents

2.1 Case Introduction

In this case we were presented with a incomplete general journal and financial statements for Rocky Mountain Chocolate Factory. The objective was to comprehend and record a variety of journal entries and post them to appropriate accounts within the journal. Then, to link the journal to the balance sheet and income statements to gain understanding of how these accounts transfer to financial statements. Finally, financial statements were prepared and formatted.

Through completion of this case I gained a deeper understanding of the process of posting and preparing financial statements. This case presented an opportunity to apply multiple concepts previously learned through accounting courses in a real-world application. Seeing firsthand the connections between journals and financial statements as well as how to effectively use excel not just for calculations but also for formatting was very interesting and valuable.

2.2 Account Analysis

Rocky Mountain Chocolate Factory is a manufacturer and retail operator with a national brand, therefore, expect to see assets such as equipment, inventories, accounts receivables, intangibles, and liabilities like accounts payable, accrued wages and expenses on the balance sheet. Major assets would likely be cash, inventory, accounts receivable, and goodwill. Major liabilities would include accounts payable, wages, and dividends payable.

2.3 General Journal

Rocky Mountain Chocolate Factory General Journal

		Beginning balance (February 28, 2009)	1. Purchase Inventory	2. Incur Factory Wages	3. Sell inventory for cash and on account	4. Pay for inventory	5. Collect receivables	6. Incur SG&A (cash/payable)	7. Pay wages	8. Receive franchise fee	9. Purchase PPE
Dr.	Cash and Cash Equivalents	1,253,947			17,000,000	- 8,200,000	4,100,000	- 2,000,000	- 6,423,789	125,000	- 498,832
	Accounts Receivable	4,229,733			5,000,000		- 4,100,000				
	Notes receivable, current	-									
	Inventories	4,064,611	7,500,000	6,000,000	- 14,000,000						
	Deferred Income Taxes	369,197									
	Other	224,378									
	Property and Equipment, Net	5,253,598									498,832
	Notes receivable, less current portion	124,452									
	Goodwill, net	1,046,944									
	Intangible assets, net	183,135									
	Other	91,057									
Cr.	Accounts Payable	1,074,643	7,500,000			- 8,200,000					
	Accrued salaries and wages	423,789		6,000,000					- 6,423,789		
	Other accrued expenses	531,941						3,300,000			
	Dividend Payable	598,986									
	Deferred Income	142,000								125,000	
	Deferred Income Taxes	827,700									
	Common Stock	179,696									
	Additional Paid-In Capital	7,311,280									
	Retained Earnings	5,751,017									
	Sales	0			22,000,000						
	Franchise and Royalty Fees	0									
Dr.	Cost of Sales	0			14,000,000						
	Franchise Cost	0									
	Sales and marketing	0						1,505,431			
	General and administrative	0						2,044,569			
	Retail operating	0						1,750,000			
	Depreciation and Amortization	0									
	Interest Income	0									
	Income Tax Expense	0									
	A = L + OE + R - E	0	0	0	0	0	0	0	0	0	0

Rocky Mountain Chocolate Factory General Journal

		10. Dividends declared and paid	11. All other	Unadjusted Trial Balance	12. Adjust for inventory count	13. Record depreciation	14. Wage accrual	15. Consultant's report	Pre-closing trial balance	16. Closing Entry	Post-closing (ending) balance	Actual February 28, 2010 F/S figures
Dr.	Cash and Cash Equivalents	- 2,403,458	790,224	3,743,092					3,743,092		3,743,092	3,743,092
	Accounts Receivable		- 702,207	4,427,526					4,427,526		4,427,526	4,427,526
	Notes receivable, current		91,059	91,059					91,059		91,059	91,059
	Inventories		- 66,328	3,498,283	- 216,836				3,281,447		3,281,447	3,281,447
	Deferred Income Taxes		92,052	461,249					461,249		461,249	461,249
	Other		- 4,215	220,163					220,163		220,163	220,163
	Property and Equipment, Net		132,859	5,885,289		- 698,580			5,186,709		5,186,709	5,186,709
	Notes receivable, less current portion		139,198	263,650					263,650		263,650	263,650
	Goodwill, net		-	1,046,944				no entry	1,046,944		1,046,944	1,046,944
	Intangible assets, net		- 73,110	110,025					110,025		110,025	110,025
	Other		- 3,007	88,050					88,050		88,050	88,050
Cr.	Accounts Payable		503,189	877,832					877,832		877,832	877,832
	Accrued salaries and wages			-			646,156		646,156		646,156	646,156
	Other accrued expenses		- 2,885,413	946,528					946,528		946,528	946,528
	Dividend Payable	3,709	- 1	602,694					602,694		602,694	602,694
	Deferred Income		- 46,062	220,938					220,938		220,938	220,938
	Deferred Income Taxes		66,729	894,429					894,429		894,429	894,429
	Common Stock		1,112	180,808					180,808		180,808	180,808
	Additional Paid-In Capital		315,322	7,626,602					7,626,602		7,626,602	7,626,602
	Retained Earnings	- 2,407,167		3,343,850					3,343,850	3,580,077	6,923,927	6,923,927
	Sales		944,017	22,944,017					22,944,017	- 22,944,017	0	22,944,017
	Franchise and Royalty Fees		5,492,531	5,492,531					5,492,531	- 5,492,531	0	5,492,531
Dr.	Cost of Sales		693,786	14,693,786	216,836				14,910,622	- 14,910,622	0	14,910,622
	Franchise Cost		1,499,477	1,499,477					1,499,477	- 1,499,477	0	1,499,477
	Sales and marketing			1,505,431					1,505,431	- 1,505,431	0	1,505,431
	General and administrative		- 261,622	1,782,947			639,200		2,422,147	- 2,422,147	0	2,422,147
	Retail operating			1,750,000			6,956		1,756,956	- 1,756,956	0	1,756,956
	Depreciation and Amortization			-		698,580			698,580	- 698,580	0	698,580
	Interest Income		- 27,210	- 27,210					- 27,210	27,210	0	- 27,210
	Income Tax Expense		2,090,468	2,090,468					2,090,468	- 2,090,468	0	2,090,468
	A = L + OE + R - E	0	0	0	0	0	0	0	0	0	0	

2.4

Rocky Mountain Chocolate Factory
Income Statement
For Year End February 28, 2010

Revenues				
Sales	....	$ 22,944,017		
Franchise and Royalty Fees	....	5,492,531		
Total revenues	....		$	28,436,548
Costs and Expenses				
Cost of sales, exclusive of depreciation and amortization expense of $336,009, $370,485 and $389,273	....	14,910,622		
Franchise Cost	....	1,499,477		
Sales and 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	....	-		
Interest Income	....	27,210		
Other, net				27,210
Income Before Income Taxes				5,670,545
Income Tax Expense				2,090,468
Net Income			$	3,580,077
Basic Earnings per Common Share				0.60
Diluted Earnings per Common Share				0.58
Weighted Average Common Shares Outstanding		....		6,012,717
Dilutive Effect of Employee Stock				197,521
Weighted Average Common Shares Outstanding, Assuming Dilution		....		6,210,238

2.5

Rocky Mountain Chocolate Factory
Balance Sheet
As of February 28, 2010

Assets				
Current Assets				
Cash and Cash Equivalents	$	3,743,092		
Accounts receivable, less allowance for doubtful accounts of $395,291 and $332,719		4,427,526		
Notes receivable, current		91,059		
Inventories, less reserve for slow moving inventory of $263,872 and $251,922, respectively		3,281,447		
Deferred Income Taxes		461,249		
Other Assets		220,163		
Total current assets			$	12,224,536
Property and Equipment, Net				5,186,709
Other Assets				
Notes receivable, less current portion		263,650		
Goodwill, net		1,046,944		
Intangible assets, net		110,025		
Other		88,050		
Total other assets				1,508,669
Total assets			$	18,919,914
Liabilities and Stockholders' Equity				
Current Liabilities				
Accounts Payable		877,832		
Accrued salaries and wages		646,156		
Other accrued expenses		946,528		
Dividend Payable		602,694		
Deferred Income		220,938		
Total current liabilities				3,294,148
Deferred Income Taxes				894,429
Commitments and Contingencies				-
Stockholders' Equity				
Preferred stock, $0.10 par value; 250,000 authorized; 0 shares issued and outstanding				
Series A Junior Participating Preferred Stock, authorized 50,000				
Undesignated series, authorized 200,000 shares				
Common stock, $0.03 par value; 100,000 shares authorized; 6,026,938 and 5,989,858 shares		180,808		
Additional Paid-In Capital		7,626,602		
Retained Earnings		6,923,927		
Total Stockholder's equity				14,731,337
Totally liabilites and stockholder's equity			$	18,919,914

2.6 Cash Flow Analysis

For each transaction, indicate whether the transaction would appear in the "operating," "investing," or "financing" section of the statement of cash flows.

1. Does not affect cash flow, would be added back to the operating section if using the indirect method.

2. Does not affect cash flow, would be added back to the operating section if using the indirect method.

3. Appears in the 'operating' section of cash flow.

4. Appears in the 'operating' section of cash flow.

5. Appears in the 'operating' section of cash flow.

6. Appears in the 'operating' section of cash flow.

7. Appears in the 'operating' section of cash flow.

8. Appears in 'operating' section of cash flow.

9. Appears in 'investing' section of cash flow.

10. Appears in 'financing' section of cash flow.

11. Varies based on transaction.

12. Does not affect cash flow, would be added back to the operating section if using the indirect method.

13. Does not affect cash flow, would be added back to the operating section if using the indirect method.

14. Does not affect cash flow, would be added back to the operating section if using the indirect method.

15. Does not affect cash flow.

Internship Scenarios

Professional Experience Case

Prepared By: Caroline McLeod

September 12th, 2018

Table of Contents

3.1 Case Introduction

This case featured a collection of scenarios related to the accounting program at Ole Miss and, more specifically, the internship recruiting and selection process. The intended effect of this case was to use critical thinking skills and place ourselves in the shoes of these students determining whether we agreed with their thought process and why or why not. All three scenarios are very likely to relate to each student in one way or another and encourage preemptive consideration of the effect our plans and actions may have on our future careers.

Through in-class debate and reflection on these three scenarios, I learned a lot about myself and my view on these topics. I related most closely to the scenario involving a student whose ultimate goal was to be an investment banker but had decided to major in accounting for the reputation and streamlined internship program. I myself have considered the possibility of going into financial planning but knew that the workload and prestige of working for a Big Four could help further my career in any financial field. This was a great topic of discussion because it helped me to consider the consequences and potential benefits of taking this path. One of the most valuable things I learned through our discussion was the rate of return that these firms realize when hiring interns. I have always planned on staying with whatever firm I intern with for at least a few years to work my way up the ladder and gain even more experience but seeing actual figures on how much firms spend recruiting and training interns solidified this plan even more for me.

3.2 Scenario 1

The first scenario involved a student who was interested in a career in tax law. He looked up to his family member who was a tax lawyer and was entertained with the idea of making more money than a normal tax accountant. He was still planning to pursue an internship with a Big Four accounting firm for the experience.

I originally disagreed with this student's plan, specifically because I do not believe that choosing a career based on earning potential is a smart choice. If you really enjoy something, it shouldn't matter how much money you are making. Find your passion and the money will follow. However, if this student had researched the field and profession of tax law, then I would be more confident in his intentions. One great point that was brought up during debate was the idea of transparency with the internship recruiters. Several students pointed out that the experience of an internship could offer potential benefits for the student in law school and look great on a resume. However, it would be advisable to be up-front about his career aspirations with the recruiters so that they are aware of the possibility of not retaining him as a full-time employee. If this student is sure about his career choice, I see no issue with pursuing a tax internship for the exposure and professional development. That is, if he is clear about his intentions.

3.3 Scenario 2

The next scenario presented two students who had chosen to major in accounting due to the reputation and ranking of the Patterson School of Accountancy. However, these students were explicit that their goal was to function as consultants or investment bankers. They too were pursuing the internship path, but more specifically to prove their commitment to a certain location as well as ability to handle a heavy workload.

During this debate, the two main points that prevailed throughout the discussion were that a) there is not a simple track for other financial fields like there is for accounting, and b) transparency with the firms is important but you should still be skeptical about their willingness to accommodate your specific needs. Several people brought up the possibility of double-majoring or minoring in the field of study that the student is interested in pursuing if they choose to have their original degree in accounting. Many of us agreed that getting a degree in accounting is not a bad starting point as it is considered ‘the language of business’ and would be useful no matter where you end up. When it came to the debate on transparency, the class was torn between the idea of ‘taking up spots’ in regard to accounting internships while some people believed that if you are qualified and capable you should not feel bad about taking an internship. It is important to remember that these internships are not just exploratory, short term positions but rather serious steps in pursuit of a professional career in public accounting. Only the very best students would truly have the opportunity to explore into other fields during their internship, so students should not be fooled into thinking that firms are going to cater to your chosen field when they know they could lose their investment in you.

3.4 Scenario 3

In the third and final situation, a student has contacted Dr. Dickinson about the possibility of transferring his job offer from his internship location of Washington D.C. to his hometown of Dallas, Texas. He wanted to know the possibility of a transfer and how to go about requesting that.

This was a relevant scenario for everyone going through the internship recruitment process because it is important to have a very serious conversation with yourself about the where you want to go for your internship and why. We did discuss the possibility of personal circumstances that might come up and require a change, but this is obviously a worst-case-scenario and does not happen to everyone. We also considered the firms' total output for recruiting and hiring interns, which is upward of $100,000 and as some of that cost is born by the actual office rather than the firm as a whole, it is advisable to choose an office that you can commit to so they can see return on their investment. Something that came up frequently was the idea of being a 'high-performer' and how this can affect your options. I think it is always good to do your best and being rewarded for that is great, however, I don't think it is appropriate to assume that just because you are good at your job you can take advantage of the system. One thing I hope to gain from my internship is not only experience in the real world, but a solid foundation of relationships and reputation at a specific office location. These are all important aspects to consider when choosing a location in order to set yourself up for success!

Accounting for Debt Securities Sales and Impairments

Securities Sales Case

Prepared By: Caroline McLeod

September 26th, 2018

Table of Contents

4.1 Case Introduction

This case involves the analysis and application of rules regarding the impairment of debt securities, and specifically in relation to securities sales. Generic Bank's portfolio is presented and noted to contain material unrealized losses. The bank's CFO wants to increase cash on hand to pay bonuses and prepare for future strategic acquisitions and has determined that the sale of debt securities is a viable way to accomplish this goal. However, there are possible consequences when it comes to financial reporting of security sales due to the timing, nature, and necessity of these sales. Five scenarios are presented for discretion on how to record these securities sales. A sale of seven securities is made in 2013 but impairment could be reported in 2012. Also, impairment decisions must be made for the remaining securities after this sale.

I really enjoyed this case and learned a lot not only about financial reporting of a specific expense but also about the FASB codification and bank regulations. This was an interesting topic because it is not something that we have discussed in depth in any of our classes thus far and so it required a significant amount of research as well as critical thinking. On some of the scenarios, the answer is subject to interpretation. This can often be the case in accounting, and so learning to form judgments after extensive research and based on professional knowledge is a great skill to develop even in our undergraduate years.

4.2 Part 1

1. Assume that Generic Bank does sell the aforementioned securities shortly after year end in early 2013. Does Generic Bank have an impairment loss on the seven securities designated above in 2012.
    a. According to FASB Codification FAS 115-2 and FAS 124-2 "An investment is impaired if the fair value of the investment is less than its amortized cost basis." This is the case for all seven identified securities. Furthermore, Generic Bank had no intention to hold these securities until their unrealized losses recovered. They were always planning to sell them in order to raise capital for bonuses and strategic acquisitions. This is addressed in the same FASB Codification, "Board believes it is more operational for an entity to assess whether the entity (a) has the intent to sell the debt security or (b) more likely than not will be required to sell the debt security before its anticipated recovery." Joshua Winters considered selling these securities towards the end of 2012 and therefore should have recognized the impairment at that time. Although the determination was made that no credit losses are present, the second requirement to avoid impairment that comes into question is the intent to hold the securities. It is very clear that Joshua Winters at Generic Bank had identified the sale of these securities as a source of cash that was needed soon and therefore had intent to sell them.

2. Assume that Generic Bank does sell the aforementioned securities shortly after year end in early 2013. 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?

    a. The recognition of the other securities impairment depends on Generic Bank's new or continuing strategy for 2013. If excess capital is no longer needed after the original seven securities are sold, then the remaining securities are not intended for sale and would not incur an impairment loss. However, if there is a need for more capital, and the sale of the remaining securities are identified to satisfy this, they are then intended for sale and would be impaired. Although Generic Bank has classified all securities as held for sale, this was due to declines in interest rates as opposed to credit losses. According to ASC 320-10-35-33A, if they expect to recover the entire amortized cost of the securities, an impairment would only be necessary if sale was intended or required before the recovery. An RSM 'Insight Article' related to guidance on impairment and sale considerations also mentions that consideration should be given to expected cash flows to be collected when determining if other-than-temporary impairment should be recorded. I believe that if further capital is needed, it would be advisable to explore other means such as the mentioned FHLB advances and Fed Funds. Examining the extent of impairment would help to confirm the benefits of alternative capital sources. Finally, impairment would be determined by comparing the amortized cost to the fair value at the date of impairment.

4.3 Part 2

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?
    a. I do not believe that the final answer would change because my above conclusion was based on a variety of sources and rulings that both a CFO and an external auditor would follow. However, an external auditor would be more concerned with documentation and reporting when making their assessment. She may look at the possibility of conflict of interest in the CFO increasing cash flow for bonuses that he might receive. She would want to look at documentation of the sale to determine timing and intent to sell. She would also carefully examine reporting procedures for the securities, both those impaired and those not. An external auditor would consider laws and regulations, but if control risk was determined to be low then moderate testing of controls would be enough.
    b. A bank regulator would likely reach the same conclusion because my assessment also took bank guidance into consideration, which is extremely similar to FASB guidance. A bank regulator would want to see a recovery forecast for the securities and an overall bank strategy to aid in determining intent. According to the OCC, a detailed financial analysis of why selling the debt is better than other options, proof of connection to business strategy, and a risk profile would also be part of regulatory efforts. Bank regulators assess

controls and compliance which determines control risk. He would closely examine policies and procedures surrounding sale of securities and make sure all necessary approvals take place. There are a fair number of consumer protection statutes, internal controls, and federal laws that relate to securities sales which a bank regulator would monitor.

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?
    a. An article in The Journal of Accountancy by Thomas Rees and Kenneth Fick published in 2009 and centered around a FASB Staff Position on securities impairment states that impairment assessment should be made on an individual level. In this application, a collectively net gain position is not relevant when determining impairment. For requirement 1, any security that had a fair value less than its amortized cost and was intended for sale would incur an impairment loss regardless of the overall net position for total securities. For requirement 2, it is still only necessary to record impairment on securities when intent or requirement to sell is present.
    b. If all securities were individually valued at a gain, then no impairment exists because they would be sold at fair value which is more than amortized cost if a gain is recognized. The remaining securities would still be subject to evaluation of intent to sell in the next period on an individual basis.

Now assume that Generic Bank is adequately capitalized rather than well capitalized. And the bank desires to sell securities to improve capital ratios (through the reduction of risky assets) and to fulfill other borrowing obligations as they come due. Securities may not represent the only assets available to Generic Bank to sell, but access to other forms of borrowing to meet liquidity needs has become more limited.

5. Assume that Generic Bank does sell the aforementioned securities shortly after year end in early 2013. Does Generic Bank have an impairment loss on securities other than the seven securities sold?
    a. In this scenario, the situation of the bank has changed and there is a more significant possibility that the other securities will need to be put up for sale before their losses are recovered. Because there is no black and white determination for 'intent to sell,' it is important to look at the bank's overall position. There is still adequate capital and other assets available for sale besides securities, but if the bank's strategy and the schedule of liabilities coming due necessitates large increases in cash flow, this could qualify for required sale before recovery and result in impairment. The CFO, auditors, and regulators would all look at factors that might require sale and the likelihood that these factors will occur before full recovery. The recognition of impairment at this point would rely on the CFO's judgment and future plans for securities and other assets as well as capital requirements.

City Research

Preferred Internship Cities

Prepared By: Caroline McLeod

October 31st, 2018

Table of Contents

5.1 Case Introduction

This case is an evaluation and exploration of two cities based on research in a variety of areas. This research will aid students in determining where they want to do an internship and start a career through actual metrics and not just broad ideas. It is designed to prompt critical thinking as well as factual research about two possible places that students are considering living in.

I learned a lot throughout this case, which was surprising because my number one city is actually my hometown of Denver, Colorado. Even though I have lived there all my young life, I have not ever lived by myself or worked there professionally so a lot of the information I gathered was brand new to me. The second location I chose, Seattle, is actually where I will be spending the summer following my junior year for an internship and so this research was extremely valuable and very pertinent to my current situation. I realized how important it is not just to consider the broad climate or reputation of a city when choosing where to live, but to also look at crime rates, volunteer opportunities, and modes of transportation. By looking at the daily activities I would be doing in each of the cities I got a much better idea of where I want to live.

5.2 City 1 – Denver, Colorado

a. What is the population?

   i. The population of Denver, Colorado is 704,621 people. The Denver Metro Area contains 2.88 million people.

b. Describe the climate and seasonal fluctuations.

   i. Denver is at a high elevation, but mid latitude giving it a cool, but dry climate. There are four distinct seasons with large swings in temperature but consistent day to night changes. During the summer it is hot, but with frequent rain showers and low humidity with cooler nights. The winter temperatures drop significantly but the thin atmosphere allows the constant sunshine to keep the climate comfortable. Denver is known for its 300 days of sunshine per year. The months with the most snowfall are actually March and April.

c. Describe the city's topography, scenery, and other geographic or geological features of the area in which the city is located. Include pictures where appropriate.

   i. Denver is located just east of the Rocky Mountain range at an iconic altitude of 5,280 feet above sea level. The state of Colorado includes 59 mountains of 14000 feet or higher. The eastern region of Colorado is defined by rolling prairies and occasional hills with two major river valleys. Due to its desert-tundra climate, there is not a lot of foliage in Denver. Most of the trees are aspens and evergreens or smaller shrubs. However, the scenery is beautiful because of the elevation one can view a mass of the landscape from the city.

Figure 5-1

Figure 5-2

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

   i. State: 4.63 percent (flat tax rate) would translate to $2315 per year.

   ii. Federal: 5226.25 plus 2 percent would translate to $8238.75 per year.

   iii. Combined State Sales: 7.6 percent (state, county, city)

   iv. Property: 0.63 percent

e. What transportation hubs are in the city?

   i. Largest transportation hub is Union Station in downtown Denver. This train station is a major stop along the RTD (Regional Transport District) Light Rail and Bus systems as well as the Ski Train which drops off at the base of Winter Park Resort.

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

   i. Denver's most prevalent industries include Aerospace, Aviation, Broadcast and Telecommunications, Energy, Financial Services, and IT.

g. Describe the quality of the city's healthcare?

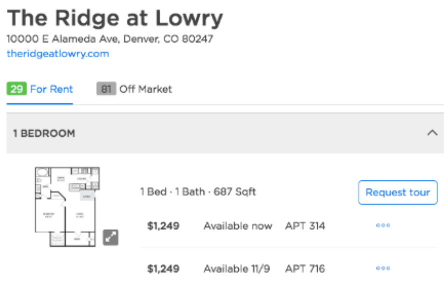
   i. Colorado was most recently ranked 6th in the country for quality of healthcare based on access to health care, cost, quality and patient outcomes. Additionally, two Colorado hospitals ranked among the best in the country. Being that Denver it heavily populated, there is ample access to healthcare and insurance.

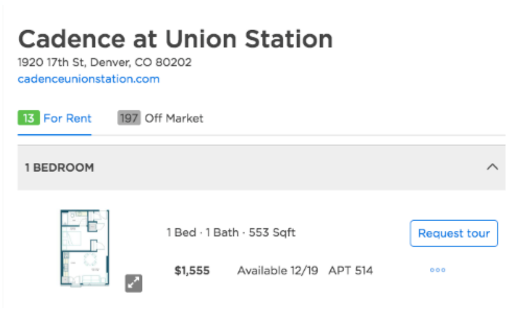
h. What types of crime are common within the city and where are the locations within the city to avoid?

   i. These are the seven most dangerous neighborhoods based on the number of offenses and crime density per square mile: Lincoln Park, Cheeseman Park, Civic Center, Lower Downtown, East Colfax, Capitol Hill, and Five Points. Most common crimes are assaults, domestic violence, homicides, robberies, sexual assault, rape, bike thefts, burglaries, car thefts, and larceny.

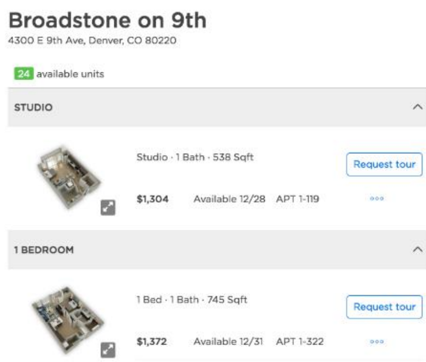
i. Based on where you see yourself living for the first three years, how much rent do you expect to pay? Back up this assertion with sample properties from each location (including pictures). Describe the square footage, amenities, need for a roommate, availability of parking, etc.

   i. I expect to pay between $1300 and $2000 per month for an apartment in Denver. All apartments in this price range were between 550 and 750 square feet, included some sort of provided parking, washer/dryer in the unit, and are single bedroom so no need for a roommate.





Figures 5-3,4,5



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

   i. Typical mode of transport in Denver is either driving or taking the RTD train. There is also the option to 'park and ride' where you park at either a designated stop and take either the bus or train into the city. Depending on how close I lived to a train stop, I would most likely drive to the park and ride lot or take the train to work. An average commute from the suburbs or lower downtown is approximately 30 minutes.

k. Where will you do your grocery shopping?

   i. I will grocery shop at either Safeway, Whole Foods, or Trader Joes which are all popular and accessible stores. I eat a gluten free diet so I tend to shop at specialty, organic stores that have more options.

l. How will you do your laundry?

    i. Depending on the amenities in my apartment complex, I would do my laundry at my apartment or perhaps have to go to a laundromat. Depending on pricing, I would consider sending my laundry out especially with such a busy schedule.

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

    i. I definitely plan on being active in the Catholic church wherever I go, there are two Catholic churches in downtown Denver, Holy Ghost and the Cathedral. I also plan to participate in the Alzheimer's Association Chapter and the Sacred Heart House.

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

    i. Colorado is great for hiking, biking, camping, and skiing. I love to be outdoors so Denver is the perfect place for all of those activities. There are also teams for every professional sport, Denver Broncos, Colorado Avalanche, Rockies, Mammoth, Rapids, and the Nuggets. There are several concert venues including the Pepsi Center and Red Rocks Amphitheatre. I will definitely get a ski pass and continue to ski at Breckenridge and Copper mountains.

o. What are the modes of traveling back to your hometown from this city? What is the average cost you'd incur for each trip back home?

i. I am originally from a suburb of Denver, about a 30 minute drive, so it would cost very little time and money to travel to see my family. The rest of my family lives in the New Orleans area and so I would fly down there for holidays. Usually tickets to New Orleans during high traffic dates would be between $250 and $300 round trip.

p. Based on your findings, develop a model monthly operating budget for each city for Year 2, assuming that with bonuses for being a high performer, your annual salary is $60,000.

Monthly Budget:		**Yearly**
Groceries/Beauty	$250.00	$3,000.00
Eating Out	$150.00	$1,800.00
Social	$100.00	$1,200.00
Clothing	$100.00	$1,200.00
Gas	$85.00	$1,020.00
Gym Membership	$50.00	$600.00
Health Insurance	$200.00	$2,400.00
Car Insurance	$125.00	$1,500.00
Rent and Utilities	$2,000.00	$24,000.00
Savings	$115.00	$1,380.00
Taxes		$15,300.00
Tithe	$500.00	$6,000.00
Phone Bill	$50.00	$600.00
total		$60,000.00

5.3 City 2 – Seattle, Washington

a. What is the population?

i. The population of Seattle, Washington is 724,745 people.

b. Describe the climate and seasonal fluctuations.

i. The cold season in Seattle sees an average temperature of 53 degrees and the warm season sees an average of 72 degrees. Expected rainfall in Seattle is 33 percent chance in the wet season, and 8 percent during the dry season. The climate is a coastal mountain climate which means that temperatures are relatively stable throughout the year.

c. Describe the city's topography, scenery, and other geographic or geological features of the area in which the city is located. Include pictures where appropriate.

i. Seattle is located along the Puget Sound which is an inlet of the Pacific Ocean. It is located at only 187 feet above sea-level but also features Mount Rainier of the Cascade Range just southeast of the city. The Olympic mountains are also a geographical feature of the greater Seattle area.

Figure 5-6

Figure 5-7

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

  i. State: 0 percent (results in a higher sales tax)
  ii. Federal: $5,226.25 plus 25 percent would translate to $8,238.75 per year.
  iii. Combined State Sales: 10.1 percent
  iv. Property: 0.99 percent

e. What transportation hubs are in the city?

  i. The Seattle Department of Transportation has bus and train services. One of the perks of Seattle is the extremely convenient and viable transit options. There are three hubs in the city center at King Street Station, Westlake, and Coleman Dock.

f. What are the city's most prevalent industries?

  i. Seattle's most prevalent industries are aerospace, agriculture, business services, healthcare, clean technology, and IT. The Boeing Company headquarters are in Seattle as well as Amazon headquarters.

g. Describe the quality of the city's healthcare?

  i. Seattle has a great healthcare system. According to the Washington Health Alliance, the Seattle-Puget Sound area has outstanding access to care and several highly rated facilities, both hospitals and clinics, in the city.

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

  a. The most dangerous areas in Seattle include Magnolia Blvd, Lake City, Bryn Mawr, and 45th Ave N. Seattle has a very low crime index rating, meaning it is on the lower spectrum of safe cities in the US, but most of this is non-violent property crimes. The robbery rate in Seattle is the only rate higher than average US rate.

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

  i. My monthly rent would be between $1,500 and $2,500 depending on what area of the city I lived in. This would include amenities like parking, outdoor pools and patios, washer/dryer, and often a gym. The pricing is pretty similar between one and two bedrooms on a per-person basis so it wouldn’t matter if I couldn’t find a roommate because I could find a one-bedroom place for about the same cost. Average square footage is between 500 and 700sqft.

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

  i. Typical commutes include driving, walking, or public transport such as buses and trains. I would most likely walk or take public transport to work depending on how far away I live. I do not plan on having a car if I lived in

Seattle because they have very efficient public transport and the city is very small and accessible.

k. Where will you do your grocery shopping?

i. I would shop at either Fred Myer, Trader Joes, Safeway, Whole Foods, or PCC. All of these have convenient downtown locations that would be easily accessible by public transport or walking.

l. How will you do your laundry?

i. Depending on the amenities in my apartment complex, I would do my laundry at my apartment or perhaps have to go to a laundromat. Depending on pricing, I would consider sending my laundry out especially with such a busy schedule.

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

i. I would, again, want to stay involved in the Catholic church wherever I go. Christ Our Hope and Sacred Heart are both located in the downtown Seattle area. The Outdoors for All foundation is also something I would be interested in joining. I would also like to participate in the Seattle chapter of the Alzheimer's Association.

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

i. Seattle also has lots of professional sports teams, the Seahawks, Mariners, and Supersonics just to name a few. I also have the best of both worlds, coast and mountains. I can ski, boat, fish, or hike. There are also many museums and attractions such as the Chihuly Glass Gardens, the Space Needle, the Amazon Spheres, and the Pike Place Market.

o. What are the modes of traveling back to your hometown from this city? What is the average cost you'd incur for each trip back home?

i. I would have to fly back home to Denver from Seattle, roundtrip tickets cost an average of $200. From Seattle to New Orleans where the rest of my family lives would be around $250.

p. Based on your findings, develop a model monthly operating budget for each city for Year 2, assuming that with bonuses for being a high performer, your annual salary is $60,000.

Monthly Budget:		**Yearly**
Groceries/Beauty	$250.00	$3,000.00
Eating Out	$150.00	$1,800.00
Social	$100.00	$1,200.00
Clothing	$100.00	$1,200.00
Gym Membership	$50.00	$600.00
Health Insurance	$200.00	$2,400.00
Transportation	$50.00	$600.00
Rent and Utilities	$2,400.00	$28,800.00
Savings	$115.00	$1,380.00
Taxes		$12,420.00
Phone Bill	$50.00	$600.00
Tithe	$500.00	$6,000.00
total		$60,000.00

5.4 Evaluation and Conclusion

Finally, based on your full analysis, determine whether you still want to live in both cities, and if so, which one is your preferred city and why?

I definitely still want to live in both of these cities. I would probably prefer Denver mostly because it is my hometown and I love it there already. But I also am seriously considering Seattle after this research because I have learned a lot of new information and some great perks to living in that city as well. There is something to be said for getting out of your comfort zone and trying something new.

WorldCom Case

Capitalized Cost and Earnings Quality

Prepared By: Caroline McLeod

November 7th, 2018

Table of Contents

6.1 Case Introduction

This case discusses the fraudulent procedures that took place at WorldCom in the early 2000s and resulted in a massive scandal. It illustrates the proper accounting principles related to capitalization and expensing of costs. The difference in these two processes is very crucial to properly preparing financial statements and remaining in accordance with SEC guidelines as well as Generally Accepted Accounting Principles. WorldCom is a massive lesson learned when it comes to fraudulent accounting as these errors lead to the downfall of a large company and the incarceration of several executives.

This case was very eye-opening because not only does it discuss proper accounting procedures but lends insight into the consequences of these actions. It is so important, even as students, to understand the importance of ethical behavior in our careers as accountant and sometimes knowing the consequences are the best way to get that message across. By computing the physical numbers, we were able to fully comprehend the magnitude of these errors and the impact they had on not just an industry but on many people’s personal lives.

6.2 Questions

a. FASB Statement of Concepts No. 6 (a replacement for SCON No. 3), *Elements of Financial Statements*, describes the building blocks with which financial statements are constructed.

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

i. SCON 6 outlines an 'asset' as an item that is likely provide an economic benefit, such as revenues or other assets, to the entity that controls it. The control of the asset is obtained through a transaction (purchase) or other event, such as construction or fabrication.

ii. In contrast, an 'expense' is the exchange of assets, or the forming of new liabilities, due to activities of or related to distribution/manufacturing of goods, performing services, or executing the normal operations of an entity.

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

i. A cost should only be capitalized when the cost will provide future economic value and would therefore be considered an asset to the company. If the cost is for a capital expenditure, and would be defined as a long-term investment, it can be capitalized and would appear on the balance sheet as an asset with only depreciation hitting the bottom line. If the costs incurred are part of normal, ongoing operations that are central to the entity's business operations, then they are expenses that should appear on the income statement as an offset to revenue.

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.

   i. When a cost is capitalized, its initial amount is placed in an asset account. This asset is then depreciated, and classified as an expense, over an extended period of time. This means that the only expense related to that cost that would affect net income is the depreciation, will is only a small portion of the total cost and is spread out over many years. By classifying the costs as assets, the balance sheet would reflect more assets and less liabilities.

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.

   i. Dr. Line Cost (Expense) 14,739,000,000

Dr. Line Cost (Expense)	14,739,000,000	
Cr. Cash or A/P		14,739,000,000

ii. These costs are part of a third-party contract with telephone providers as part of WorldCom's service to their customers. The are recurring costs that allow 'access and transport.'

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?

i. The 'line costs' were improperly capitalized by WorldCom. They should have been expensed because they were part of the company's ongoing operations and did not meet the qualification for an asset. They were not sustainable, nor did they produce future revenue or benefit for the company. The line costs are a recurring expense that should not be capitalized.

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?

i. Dr. PPE 3,055,000,000

Cr. Line Cost (Expense) 3,055,000,000

ii. This would make the ‘line costs’ appear on the balance sheet under assets. They would flow through to a larger net income appear must higher on the statement of cash flows.

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.

i. Quarter 1: 771/22 * 4/4 = 35,045,455

ii. Quarter 2: 610/22 * 3/4 = 20,795, 455

iii. Quarter 3: 743/22 * 2/4 = 16,866,364

iv. Quarter 4: 931/22 * ¼ = 10,579,545

  i. Total = 83,306,818

v. Dr. Depreciation Expense 83,306,818

  Cr. Accumulate Depreciation 83,306,818

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 percent as an approximation of WorldCom's 2001 marginal income tax rate, in your calculations. State any other assumptions you make. Is the difference in net income material?

i.	Income, as reported (before tax)	2,393,000,000
	i. Depreciation expense (for year)	83,306,818
	ii. Improper capitalization	(3,055,000,000)
ii.	Restated loss (before taxes)	(578,693,182)
iii.	Income tax (35 percent)	202,542,613
iv.	Minority Interest	35,000,000
v.	Restated Net loss	(341,150,569)

iv. It is assumed that the minority interest benefit remains the same even with a loss before taxes. The 'creative accounting' that was done by WorldCom impacts the bottom line severely. The discrepancy is a material misstatement of earnings and is fraudulent.

Starbucks Corporation

Understanding Financial Statements

Prepared By: Caroline McLeod

March 3rd, 2019

Table of Contents

7.1 Case Introduction

This case involves an understanding and basic analysis of financial statements and reporting, specifically related to common-size balance sheets and income statements. Starbucks Corporation's financial statements, auditor opinions, and accounting policy footnotes are presented, and a variety of blanket analysis questions are posed in an effort to put these financial statements into a real-world view. Then, we worked through creating common-size financial statements that are used to pull relevant information about various aspects of the company along with other provided statements of earnings and cash flows. Through this analysis, we gain a better understanding of the wealth of information about a company that is contained in the financial statements and how to sort through them for pertinent information.

I particularly enjoyed the analytical part of this case. Throughout our undergraduate accounting studies, we often get wrapped up in the rules for 'how' to create them and can lose focus of the 'why.' Why is this information important, what can it tell us, and how do we utilize it to make decisions? All of these are critical questions that not only help in analysis but can also help in the actual preparation of these documents. If you understand how the information will be used, it becomes much easier to know what should be included.

7.2 Concepts

a. Starbucks is primarily a retail business specializing in coffee, teas, complementary food items, and related accessories. They make money by roasting and retailing coffee and other products. They have also expanded their business by licensing their trademarks to grocery stores and food service accounts, according to the notes to their financial statements.

b. The four types of financial statements commonly prepared for external reporting are (1) Income Statement, (2) Balance Sheet, (3) Statement of Cash Flows, and (4) Statement of Stockholders' Equity. Starbucks refers to these as (1) "Consolidated Statement of Earnings," (2) "Consolidated Balance Sheets," (3) "Consolidated Statements of Cash Flows," and (4)"Consolidated Statements of Equity." The 'consolidated' title of these reports means that they contain information related to the holding, or parent, company as well as its wholly owned subsidiaries.

c. The SEC regulated publicly traded corporations and requires that they prepare financial statements for external reporting purposes every quarter, or four (4) times each year at the end of March, June, September and December. Publicly traded companies also have to prepare financial statements at the end of every year. Quarterly statements are called 10-Q and yearly statements are called 10-K.

d. The management of the corporation is responsible for preparing the financial statements. Then, independent auditors will certify and opine on the preparation.

Users of the financial statements would include internal management, investors, external entities with direct or indirect financial interest in the corporation.

e. Starbuck's external auditors are Deloitte and Touche LLP. The first letter is the Auditor Opinion which certifies that an audit has been conducted and describes the process that was followed. This letter only offers an opinion stating that there are no material misstatements, everything is presented fairly, and that the reports follow Generally Accepted Accounting Principles. An Auditor Opinion does not make a judgment about financial position of the corporation or make any interpretations about the financial information. The second letter is an Unqualified Opinion which also confirms that the financial statements are prepared properly and follow GAAP, but most importantly it reviews the internal controls of the corporation that are maintained by management. The auditors opine that the internal controls are materially effective. These two letters are dated several months after year-end because the audit cannot begin until the year has ended, financial statements have been prepared, and then reviewed. This entire process can take a significant amount of time depending on the scope of the audit.

7.3 Analysis

f.

Starbucks Corporation				
Consolidated Statement of Earnings				
For Years 2012 and 2013				
	2013		2012	
Net Revenues:	Amount (millions)	% of Net Revenue	Amount (millions)	% of Net Revenues
Company-operated stores	$ 11,793.2	79.2%	$ 10,534.5	79.2%
Licensed stores	1,360.5	9.1%	1210.3	9.1%
CPG, foodservice and other	1,738.5	11.7%	1554.7	11.7%
Total net revenues	14,892.2	100.0%	13299.5	100.0%
Cost of sales including occupancy costs	6,382.3	42.9%	5813.3	43.7%
Store operating expenses	4,286.1	28.8%	3918.1	29.5%
Other operating expense	457.2	3.1%	429.9	3.2%
Depreciation and amortization expenses	621.4	4.2%	550.3	4.1%
General and administrative expenses	937.9	6.3%	801.2	6.0%
Litigation charge	2,784.1	18.7%	0.0	0.0%
Total operating expenses	$ 15,469.0	103.9%	$ 11,512.8	86.6%
Gain on sale of properties	-	-	-	-
Income from equity investees	251.4	1.7%	210.7	1.6%
Operating Income	(325.4)	-2.2%	1997.4	15.0%
Interest income and other, net	123.6	0.8%	94.4	0.7%
Interest Expense	(28.1)	-0.2%	-32.7	-0.2%
Earnings/(loss) before income taxes	(229.9)	-1.5%	2059.1	15.5%
Income taxes	(238.7)	-1.6%	674.4	5.1%
Net earnings including noncontrolling interests	8.8	0.0591%	1384.7	10.4%
Net earnings attributable to noncontrolling interests	0.5	0.0034%	0.9	0.0%
Net earnings attributable to Starbucks	$ 8.3	0.0557%	$ 1,383.8	10.4%
Earnings per share - basic	$ 0.01		$ 1.83	
Earnings per share - diluted	$ 0.01		$ 1.79	
Weighted average shares outstanding:				
Basic	749.3		754.4	
Diluted	762.3		773.0	
Cash dividends declared per share	$ 0.89		$ 0.72	

f (cont).

Starbucks Corporation				
Consolidated Balance Sheets				
For Years 2012 and 2013				
	2012		2013	
	Amount (millions)	% of Assets	Amount (millions)	% of Assets
Assets				
Current assets:				
Cash and cash equivalents	2575.7	22.36%	1188.6	14.46%
Short-term investments	658.1	5.71%	848.4	10.32%
Accounts receivable, net	561.4	4.87%	485.9	5.91%
Inventories	1111.2	9.65%	1241.5	15.10%
Prepaid expenes and other current assets	287.7	2.50%	196.5	2.39%
Deffered income taxes, net	277.3	2.41%	238.7	2.90%
Total current assets	5471.4	47.51%	4199.6	51.09%
Long-term investments	58.3	0.51%	116.0	1.41%
Equity and cost investments	496.5	4.31%	459.9	5.60%
Property, plant and equipment, net	3200.5	27.79%	2658.9	32.35%
Deferred income taxes, net	967.0	8.40%	97.3	1.18%
Other assets	185.3	1.61%	144.7	1.76%
Other intangible assets	274.8	2.39%	143.7	1.75%
Goodwill	862.9	7.49%	399.1	4.86%
TOTAL ASSETS	11516.7	100.00%	8219.2	100.00%
Liabilities and Equity				
Current liabilities:				
Accounts payable	491.7	4.27%	398.1	4.84%
Accrued litigation charge	2784.1	24.17%	0.0	0.00%
Accrued liabilities	1269.3	11.02%	1133.8	13.79%
Insurance reserves	178.5	1.55%	167.7	2.04%
Deferred revenue	653.7	5.68%	510.2	6.21%
Total current liabilities	5377.3	46.69%	2209.8	26.89%
Long-term debt	1299.4	11.28%	549.6	6.69%
Other long-term liabilities	357.7	3.11%	345.3	4.20%
Total liabilities	7034.4	61.08%	3104.7	37.77%
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	0.01%	0.7	0.01%
Additional paid-in capital	282.1	2.45%	39.4	0.48%
Retained earnings	4130.3	35.86%	5046.2	61.40%
Accumulated other comprehensive income	67.0	0.58%	22.7	0.28%
Total shareholders' equity	4480.2	38.90%	5109.0	62.16%
Noncontrolling interests	2.1	0.02%	5.5	0.07%
Total equity	4482.3	38.92%	5114.5	62.23%
TOTAL LIABILITIES AND EQUITY	11516.7	100.00%	8219.2	100.00%

g. Balance Sheet

i. Accounting Equation:

Total Assets (11,516.70) = Total Liabilities (7,034.40)

+ Total Equity (4,482.30)

ii. The three largest assets on the 2013 Balance Sheet are 'Property, Plant and Equipment,' 'Cash and Cash Equivalents,' and 'Inventories.'

2013 Proportion of Short Term Assets (5,471.40) / Total Assets (11,516.70)

= 47.51%

2013 Proportion of Long Term Assets (6,045.30) / Total Assets (11,516.70)

= 52.49%

This does seem appropriate for a company like Starbucks because they have to maintain a significant amount of inventory as well as various long-term assets like equipment, so a 50/50 split seems reasonable.

iii. Intangible assets have no physical substance, have a useful life of longer than one year (long term), and are used in current operations. They can be created or bought and can also indefinite or definite lives. Some examples include trademarks, copyrights, and patents. Goodwill is simply the excess in fair value of a company compared to the company's identifiable assets (tangible and intangible). This excess in valuation can come from a brand reputation, location, customers, etc. Goodwill can only be recognized when a company is bought or merged due to the recognition of a difference in fair market value and identifiable assets.

iv. Starbucks has both debt and equity on the Balance Sheet as sources of financing. Shareholders' Equity is listed at 4,482.3 million which relates to contributions from owners. Non-owner sources include Long-term debt at 1,299.4 million and Other at 357.7 million, and Current Liabilities at 5,377.3 million for a total of 7,034.4 million. This would lead to a proportion of 61% Non-owner sources (7,034.4/11,516.7). The Debt: Equity ratio is 1.57 (7,034.4/4,482.3).

h. Statement of Earnings

i. Starbucks recognizes revenue on an accrual basis. There are a multitude of revenue recognition policies within each of the five categories of Starbucks' business segments. Revenue from store value cards (gift cards) is recognized "when redeemed, or when the likelihood of redemption, based on historical experience, is deemed to be remote." The value maintained on the cards is contained in deferred revenue. The 'rewards' that become available to customers through the rewards program are also included in deferred revenue and are offset against revenue when they are earned. The biggest challenge for Starbucks when it comes to measuring revenue is with this unearned revenue account that contains balances for store value cards as well as many other segments. A judgement must be made on when to recognize this revenue as earned, and what qualifies a redemption being 'remote.'

ii. After reviewing the Consolidated Statement of Earnings, the largest expenses s a percentage of sales are Cost of Sales 42.9 percent (2013) and 43.7 percent (2012), and Store Operating Expenses 28.8 percent (2013) and 29.5 percent (2012).

iii. The only major change between 2012 and 2013 was in Operating Expenses. This was due to a large expenditure for 'Litigation charge.' Overall, the changes in the other operating expenses, as a percentage of sales, were insignificant.

iv. Because this expense is a one-time, unusual expense it should be reported separately so that it can be easily interpreted that the material increase in operating expenses was due to an unusual expense. If it was lumped in with the general and administrative expenses, it could appear that this expense would continue to occur in subsequent years and be a normal part of operations, which it is not. While the litigation charge is unusual, it is still an operating expense because it would have resulted from some part of operations. It does not fit into any other expense category.

v. The company was not profitable in 2013 because the total expenses exceeded the total revenues for the year. In 2012, however, Starbucks was profitable because total expenses were less than total revenues. For this analysis, my definition of ‘profitable’ is that the company turned a profit, revenues exceeded expenditures.

i. Statement of Cash Flows

   i. Net Earnings = 8.3 million (2013) and 1,383.8 million (2012)

      Net Cash Op = 2,908.3 million (2013) and 1,750.3 million (2012)

      This difference is due to the accrual basis of accounting that Starbucks uses. Net earnings are how much of the total cash has actually been earned. These net earnings are adjusted for all activities that do not affect cash to arrive at cash provided by operating activities.

   ii. Starbucks used 1,151.2 million in cash for ‘Additions for property, plant and equipment,’ as listed on the statement of cash flows for 2013.

   iii. Starbucks issued cash dividends of 628.9 million in 2013 and 513 million in 2012. Dividends declared in 2012 were 668.6 million. This means that Starbucks paid less cash dividends in 2013 than they declared in 2012 and would increase the balance of accrued dividends would increase.

j. Estimates are used in reporting the amounts for asset and goodwill impairments, stock-based compensation forfeiture rates, future asset retirement obligations, and inventory reserves; assumptions are also used to report self-insurance reserves and income from unredeemed stored value cards; and the potential outcome of future tax consequences. Estimate free accounts would include revenues, operating expenses, and income taxes.

BP p.l.c

Contingencies

Prepared By: Caroline McLeod

March 28th, 2019

Table of Contents

8.1 Case Introduction

This case aims to provide a basic understanding of the accounting process of estimating and recording contingent liabilities. The main task is to contrast the accounting for contingent warranty costs and those related to the Gulf oil spill. There is also consideration made for the costs of business interruption and the steps and auditor would need to take to ensure that this was reasonable estimate of contingencies.

This case was very unique because it tackles a situation that took place very close to our campus and while the accounting guidelines on contingent liabilities might seem straightforward, in instances such as this one there can be a lot of judgement and research involved. This is also an ongoing issue for BP and could continue to affect their accounting and auditing procedures. By looking at hard data as well as predictive analysis and qualitative research, we were able to get a more well-rounded idea of the impact this event had on not only BP, but on the communities near the oil spill.

8.2 Questions

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)?

    i. A contingent liability is defined as a potential liability that may occur depending on the outcome of an uncertain future event, so an expense may or may not be incurred by the company. Contingent liabilities would be booked only if it is both probable to occur and the amount of the liability can be reasonably estimated. These types of liabilities can arise from future lawsuits, future environmental restoration, any type of future expense. For example, if a new regulation is coming to light that requires chemical companies to investigate or restore the impact they have made on the environment, they would record a liability that is contingent upon the passing of that regulation and the amount of the expense. Contingent gains are never recorded in accordance with Generally Accepted Accounting Principles.

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?

   i. As a purchaser, the product warranty is an assurance from the manufacturer that the product is what they said it was and will work as they said it should work. If a defect does occur, the responsibility for fixing or replacing it falls on the manufacturer if the defect occurs within the 2-year warranty period. This warranty is usually included in the price of the asset and would not be separately recorded on the balance sheet.

ii. From the perspective of the manufacturer, the warranty is a part of the cost of the asset and would be recorded as a liability because the performance obligation in regard to the warranty has not been fulfilled until the time it covers has passed. Any expenses related to fulfilling the warranty are recorded when incurred and in turn will reduce the performance liability. This performance liability is considered a contingent liability from the manufacturers perspective because it is based on future events that are uncertain, i.e. defects in the product.

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?

i. The company's management would need to make judgements by attempting to estimate the contingent liabilities and warranty costs. This process involves judgement because by definition a contingent liability is the cost of uncertain events or circumstances. Management would need to make educated estimates about how many warranty claims there will be, how much they might cost, and when they will occur. This can be accomplished by observing past data on warranty claims from the same product. A claim resulting from a warranty is different than a claim for damages because the warranty liability has a related revenue account that hopefully covers the related expenses, whereas liabilities resulting from damage claims are not pre-paid for by customers and will have a more drastic effect on the company's financial position. A contingent liability estimated for claims related to the oil spill are also significantly more challenging to estimate because they occur far less frequently than warranty claims and are extremely unexpected. The recording of contingent liabilities for damages may also differ in timing because the liabilities might be estimated after the oil spill happened but in relation to future events as a result of the oil spill. Warranty liabilities are estimated when the product is sold. Damages from oil spills are much less probable and much more difficult to estimate, so they may often be overlooked until they occur. Other complicating factors include which other parties should share in the charges (i.e., BP was the majority owner and operator of the lease, but Transocean was the rig's owner and Halliburton was involved in its operation). The U.S. Justice Department can also sue all parties for violating the Clean Water Act and the Oil Pollution Act (OPA).

d. 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. What kinds of industries and businesses were affected by the oil spill and would they have grounds to sue for business interruption? How would an auditor form a boundary around the potential losses that have been booked and determine if they are accurate? Should BP have booked more or less contingent liabilities?

i. BP must estimate contingencies for lawsuits brought on by businesses who were affected, claims for environmental and personal damages caused by the spill, and any expenses that BP would incur to keep its business running. The Deepwater Horizon oil spill was thought to have irreparably damaged fishing, tourism, and employment in the region that it affected. The people and businesses that experienced these effects could likely win lawsuits related to business interruption damages if they had reasonable proof of actual profits lost. The fact that businesses would be affected was quite clear, but it is very difficult to properly estimate monetary amounts and this is where BP might be have been able to win on cases of business interruption. If BP could prove that these businesses had no real evidence or quantitative information to support their claims, the courts could rule in their favor simply for being overreaching.

ii. There was also cause for concern regarding the impact on the climate and what BP's future corporate social responsibility related to environmental effects might be. The contingent liabilities recorded might need to include the cost of future efforts to prevent something like this from happening again such as safety measures, transparent reporting, and ensuring their shareholders of their ability to respond to accidents like this one. Lawsuits for climate change damages are also incredibly difficult to estimate but courts might be more likely to accept large amounts because of the more widespread impact of such damages. This is where an auditor might need to be conscious of boundaries related to contingencies. They would need to consider how far into the future the contingencies need to cover and what type of damages are actually probable and estimable. Damages from ongoing lawsuits would certainly need to be recorded as contingencies, but does BP also need to record lawsuits that have not happened yet, and how probable such lawsuits are to occur.

iii. BP booked almost $40 billion in damages related to the oil spill. This was probably a relatively good estimate at the time, but they still could have booked more because the cost to date is $62 billion. However, the cost and contingencies related to the oil spill were under so much scrutiny that BP most likely made this estimate to the best of their abilities and the unprecedented nature of this type of catastrophe made it very difficult to accurately record contingencies.

The Wendy's Company

Equity Investments

Prepared By: Caroline McLeod

April 3rd, 2019

Table of Contents

9.1 Case Introduction

In this case, parent company Wendy's has purchased a 50 percent share in Tim Horton's. This case involves developing an understanding of why companies undertake joint ventures and other strategic investments as well as how to account for these equity method investments. We then used financial statements and footnotes to analyze joint-venture activity and disclosures which aided in quantifying the impact of certain alternative accounting treatments on financial statements.

I thought this was very interesting to look at a real company who acquired a share of another company and consider all of the effects that might have on the parent company's financials. This case was a great way to revisit many of the topics we have been learning in intermediate accounting and the future topics we will cover in advanced accounting regarding the equity method. Once we understand the concepts, it is important to apply those concepts to real financial statement analysis and be able to utilize that knowledge to effectively answer questions.

9.2 Case Questions

a) In general, why do companies enter into joint-venture agreements?

   i. Companies enter joint-ventures because they are often easier and far less complicated than full mergers or acquisitions. In a joint venture, each entity retains their own unique identities, branding, and processes, but can still pool their resources and influence to execute a special project or operation. The companies get to retain their respective portions of profits and losses, but they also share in the risk of the project. Joint ventures have certain tax and legal implications that can often be beneficial to both parties.

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.

   i. The equity method is applied to Wendy's joint venture with Tim Horton's because they have purchased a significant influence in the company. When one company purchases a share in another, if they buy between 20-50 percent of the company then it is assumed that they have 'significant influence' over the company they purchased unless there is evidence that contradicts that. This 'significant influence' means that the purchaser of the share owns enough shares to be able to influence some of the operations and financial decisions of the investee. The equity method is used in these cases because it is more correct to track income through an equity income account because of the way this account appears on the balance sheet and income statement as well as how the investment is affected by dividends and earnings. In equity investments, when the investee generates income, the investor records that income as an increase to the investment account to show that the investment has increased in value. When the investee pays out dividends to its owners, the investor receives cash, but instead of recording income, it decrease the equity investment account to demonstrate that the ownership in that entity has transferred from the equity investment to a cash asset.

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?

   i. When the investment in another company exceeds the investor's share of net assets, this excess valuation can be attributed to two things. The first is an Acquisition Accounting Premium (AAP), which captures the difference in fair market value of the assets at the time of the acquisition and results in the assets attributable to the investor be written up to that fair value. Any remaining excess investment would be attributed to Goodwill, which can consist of a variety of intangible things such as branding, market share, and customer loyalty. These two things increase the value of the equity investment being purchased and therefore increase the purchase price. The fair value difference resulting from the AAP would eventually capture the depreciation of the excess in fair value of the assets now attributable to the investor company.

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?

i. In Note 8 the amounts listed for the Equity investment – Joint Venture with THI described are $89,370,000 in 2012 and $91,742,000 in 2011. These appear in the investments section of the balance sheet along with all other equity investments as well as the cost investments. The income earned from TimWen is included in 'Other operating expense, net" on the income statement.

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?

i. The balance of the investment in Joint Venture with Tim Hortons Inc. at the end of the period (2012) is $89,370. The net assets of Tim Hortons equal $70,565, so Wendy's share (50%) of net assets is $35,283. This excess amount consists of AAP (Acquisition Accounting Premium) and Goodwill. This account represents Wendy's ownership interest in Time Horton's Inc.

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

i. 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?

    i. The equity method resulted in income of $13,680 comprised of share of income less excess amortization; this amount is included in earnings before taxes as disclosed in Note 8 under ‘Equity in earnings for the period.’

ii. Prepare the journal entry to record Wendy’s share of TimWen’s 2012 earnings.

    i. Dr. Equity Investment 13,680

       Cr. Equity Income 13,680

iii. 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.

    i. The amount of amortization taken on the purchase price adjustments is $3,129 as listed under ‘Amortization of purchase price adjustments’ and using a 21-year aggregate life. This would be recorded with the following entry:

       Dr. Equity Income 3,129

       Cr. Equity Investment 3,129

iv. 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.

i. Dividends received by Wendy's for their joint venture with Tim Horton's are $15,274. This would be recorded with the following entry:

Dr Cash	15,274	
Cr Equity Investment		15,274

g) Consider the information in the statement of cash flows.

i. 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.

   i. In Note 8, the share of equity losses in the Japanese venture is $1,827 combined with TimWen's income $10,551 resulting in net income of $8,724. This equity income is not received in cash but is attributed to income from the equity investment and therefore included in net income. This would result in a deduction on the statement of cash flows using the indirect method because it is a non-cash activity that has been included in net income.

ii. 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.

i. There were no dividends paid by the Japanese venture, but dividends from TimWen totaled $15,274. The dividend receipt does not get reported in the income statement because it is as a result of an equity investment and therefore would get credited to the equity investment account. The dividends would need to be added to net income using the indirect method because they are a cash item that was not originally included in net income.

Johnson and Johnson

Requirement Obligations

Prepared By: Caroline McLeod

April 10th, 2019

Table of Contents

10.1 Case Introduction

In this case, we are tasked with reading and interpreting retirement benefit (pension) footnotes in an effort to understand the difference between expensing and funding retirement benefit obligations. Then, we will evaluate the impact of actuarial assumptions on pension expense, assets, and obligations.

I thought this was very interesting to look at the real effect of pension obligations on a company's books. This case was a great way to revisit many of the topics we have been learning in intermediate accounting and the future topics we will cover in advanced accounting regarding retirement obligations. Once we understand the concepts, it is important to apply those concepts to real financial statement analysis and be able to utilize that knowledge to effectively answer questions.

10.2Case Questions

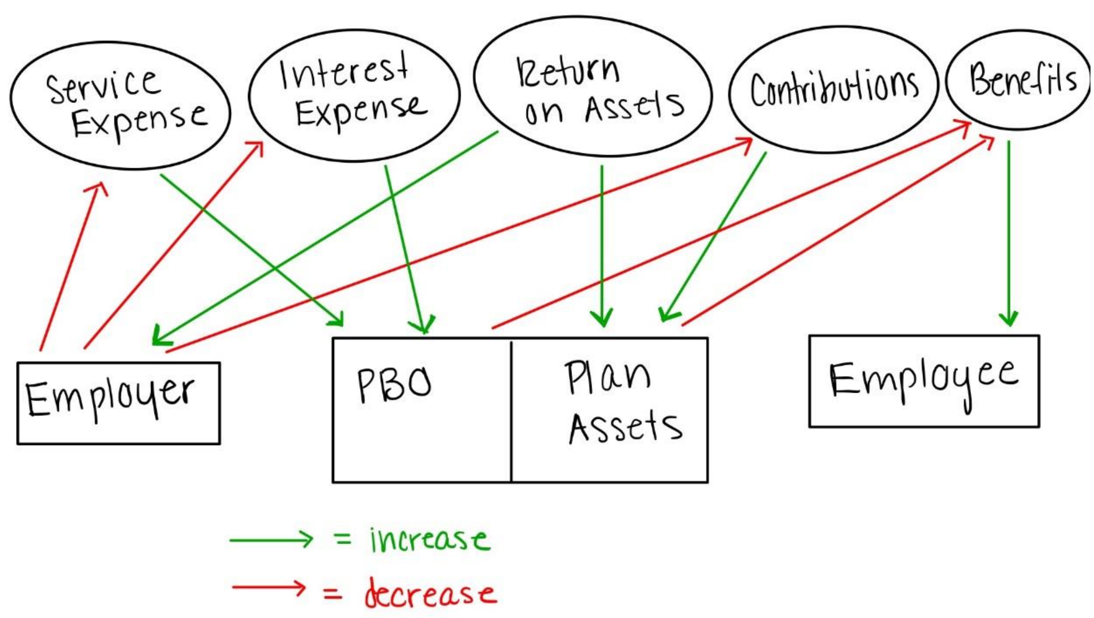
a. There are two general types of retirement (i.e. pension) plans—defined benefit plans and defined contribution plans.

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

        i. A defined benefit plan is a retirement plan that pays out a predetermined amount that is calculated by an actuary based on a variety of factors including projected years of service and future salaries. The employer bears the risk in a defined benefit plan because they are responsible for managing the pension obligation and ensuring there is enough contributions to plan assets to cover the benefits promised. A defined contribution plan is where the employee makes payments to their own retirement plan that are then matched by the employer. The employee bears the risk in a defined contribution plan because they are responsible for managing their own retirement fund, whatever they contribute is what they will get out.

ii. Explain why retirement plan obligations are liabilities. Draw a flowchart that shows the three entities involved in the PBO.

   i. Retirement plan obligations are liabilities because they accrue over long periods of time and will not become due until many years in the future. The retirement fund has been promised to the employees in some capacity and so entries must be made to track



the expenses related to the retirement obligation over the years in order to estimate the eventual payment, thus creating a liability.

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

    i. The company must make assumptions about how long the employee will work for them, when they will retire, and how long the employee will live. The Pension Benefit Obligation (PBO) is also estimated using predicted future salaries, so this assumption must also be made. There will also be assumptions made in regard to the expected return on plan asset investments.

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.

    i. Service cost is the annual increase in pension obligation that results from an employee working for another year. Interest cost is the interest that accumulates on the liability of the PBO. Actuarial gains or losses are returns that are expected and then realized on the investments made with the plan assets. Benefits paid to retirees is when the plan assets are distributed to retired employees and the PBO is reduced, essentially the liability vests and is paid out.

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.

    i. The actual return on investments is when the plan assets are invested and return dividends or interest, this would increase the plan assets. The company will start with an estimate about how much of a return it expects on plan assets, and then at the end of the year it must report the returns it realizes. Contributions are amounts paid into the pension plan which will increase the plan assets. Benefits, however, reduce the plan assets by paying out retirement funds to retired employees and in turn will reduce the PBO liability.

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.

    i. A return on assets in respect to plan assets is an expected return that is estimated for the plan assets. This expected return is then compared to the actual return and the gain or loss will be amortized into pension expense. Pension expense uses the expected return to reduce market-induced volatility in the income statement.

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?

    i. Other benefit plans are usually paid out while an employee is still working for the company and are viewed more as current expenses related to employee compensation. Retirement plans, however, accumulate over time and are paid to the employee only after they retire. Other benefit plans are not usually 'funded' like retirement plans are in the sense that another company manages a fund by investing plan assets that will produce returns. The company can modify the terms of other benefits, but retirement benefits are strictly defined future obligations.

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?

        i. $646 million is reported in pension expense under 'net periodic benefit cost.'

ii. Prepare the journal entry to record the service cost and interest cost portion of the 2007 pension expense.

i. *In millions*

Dr. Pension Expense	1,253	
Cr. PBO – Service Cost		597
Cr. PBO – 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?

i. The projected benefit obligation at the end of 2007 is $337 million. This balance represents the projected liability to retired Johnson and Johnson employees. This number is fairly reliable and is assumed reliable until proven otherwise, but it is still an estimate based numerous 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.

i. The interest cost for 2007 is $656 million. The average interest rate used to calculate this would have been 5.62 percent. This can be determined by dividing the interest cost by the beginning of year

PBO, adjusted for prior service amendments. This rate would be deemed reasonable by comparing it to similar pension plans on the market, which are provided in the notes of 6.5 percent discount rate for US and 5.5 percent for international, the 5.62 percent is in between these and would be assumed reasonable.

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?

  i. Pension benefits paid out during the year total to $481 million as shown in 'Benefits paid from plan.' Johnson and Johnson would not have paid cash for these benefits, they would have been taken out of the existing plan assets, which would have previously contributed to with cash. Paying these benefits out decreases the pension benefit obligation, because this is no longer a liability that is owed, and will also decrease the plan assets because this is where the benefits are paid from.

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?

    i. The value of plan assets at the end of 2007 is $10,469 million. This value is comprised of the fair value of the all contributions and investments that Johnson and Johnson made to its retirement plan that will eventually be distributed to retired employees.

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?

  i. In 2006 the expected return on plan assets was $701 million, but in 2007 it rose to $809 million. The actual return for 2006 was $966 million and in 2007 it was $743 million, an underestimation. In 2007 this difference is only 8 percent from estimate-actual, but in 2006 that difference was a 27 percent difference, which is fairly significant. Actual return will more accurately reflect the company's pension expense because it is measured using the actual economic environment as opposed to assumptions about the economic environment.

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.)

  i. Johnson and Johnson contributed $317 million and its employees contributed $62 million for a total of $379 contributions made in 2007. In 2006, however, the company only contributed $259 million and $47 million for a total of $306 million.

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

    i. According to the notes, the retirement assets are in equity securities, debt securities, and real estate.

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 company's balance sheet?

    i. The company's retirement plan is underfunded by $2,122 million in 2006 and by $1,533 million in 2007. This can be found in the 'Funded status at end of year' line under the Change in Plan Assets section. The funded status can also be found in the future projected contributions table.

On the Balance Sheet-Based Model of Financial Reporting

Equity Investments

Prepared By: Caroline McLeod

April 17th, 2019

Table of Contents

11.1 Summary

In 'On the Balance Sheet-Based Model of Financial Reporting,' author Ilia D. Dichev provides a presentation and analysis of the major reasons why the balance sheet orientation of accounting-standards is flawed before concluding with a suggestion for a better model. First, a brief history and background of current developments in accounting is presented. The two approaches, balance sheet and income statement, are discussed citing that the balance sheet approach views the valuation of asset and liabilities as the primary goal of financial reporting while the income statement approach views the determination of revenues, expenses, and earnings as the primary goal. Historically speaking, the income statement approach was dominant until the mid-1970s, although financial accounting has always been a compromise between the two approaches. It was not until FASB became the official standard setter of the U.S and set out on a mission to redefine the conceptual framework that it became clear that only one approach could reign supreme. The FASB's choice was supported by the idea that earnings cannot be determined without defining the value of such earnings in terms of assets and liabilities, a balance sheet-based approach. Following this decision, many changes were adopted to solidify this concept, with moves towards "fair value" accounting demonstrating balance sheet superiority in the extreme. FASB's determinations expanded beyond the U.S. to become a major player in the formation of international standards. FASB continues to shape the Conceptual Framework; a key event in this process was the issuance of 'Preliminary Views' that indicated FASB's vision and asked for feedback, all the while solidifying the balance sheet model.

Next comes the discussion of four major issues with the adopted balance sheet approach. The first point is that the balance sheet does not follow the way that businesses operate and create value. A major theme within business is to incur expenses in an effort to drive earnings. With this view, assets are not the primary focus, but the use of the assets and the incurring of liabilities as a means to the end of earning revenue. Whether this process occurs only once, advance an expense to then earn a revenue, or over and over again, there is no change to the nature of the use of assets. The lasting impact, and therefore the primary accounting concern, should be with the cumulative amount of revenue produced. The other key part of this area of critique is that the managers of a firm are following an income statement approach, forecasting revenues and then predicting the costs that would produce those revenues, and so the accounting process should follow. Finally, investors (who are the main users of financial reporting information) also rely on earnings to make decisions. All of these items make it clear that the model of business should be the model of accounting, with income statement consideration at the forefront. A quantitative approach is also presented in this section, citing that the ratio of PPE to Depreciation is relatively consistent over several years and the sales of PPE is proportionally small to the level of PPE. Both of these considerations demonstrate that an asset-based approach would be much more useful to internal users than external. There is one caveat to this issue at hand in that a balance sheet approach would be relevant to a firm whose primary value was created through the marketing and sale of assets, but this is a large minority of businesses and business activity. These would be considered financing activities, but operating activities would still be income-statement oriented.

The second issue in the balance sheet approach comes from the lack of clarity about its superiority, and even a claim that income would be a stronger foundation for financial reporting. The FASB chose the build the structure of its conceptual framework on the foundation of the 'asset' as the most fundamental part of accounting, with all other pieces as essential derivations from an asset. However, this foundation is rooted in the definition of an asset which is a 'probable future economic benefit' which could also be redefined as the production of income, the most economical benefit there is. Hence, the idea of an asset cannot be separated from the idea of income. Income is derived from assets, and assets are only assets because they produce income. There is no real reason why one should be superior to the other, they are reliant on one another and when it really comes down to it, the income produced by an asset is often more tangible than the asset itself. The other piece of income that provides more clarity is the concept of time and operations over a period of time. The amount of income a firm generates over a year is a much more comprehendible to external users than the elusive concept of assets without knowledge of their operational use. Intangible assets also exaggerate this problem because they frequently rely on valuation and forecasting in contrast to the realized income from such assets.

A third consideration in the critique of balance-sheet based financial accounting is its contribution to the decline of forward-looking usefulness of earnings. As previously mentioned in the article, investors are primary users of financial reporting, and its has been revealed over and over again that these investors value earnings as a critical part of analyzing a firm. The earnings that investors find most predictive is not the change in assets, but the recurring earnings and current earnings. These metrics are much more likely to persist than the historically unpredictable changes in market value that the balance-sheet approach relies on to value assets. This is not just a theory but is quantified in a study of empirical earnings during the last 40 years which shows extreme volatility that does not match with the minor changes in underlying revenues and expenses for the same time frame. The volatility is traced to the non-recurring revenue that stems from revaluation mandated by the balance-sheet approach. Because this approach has been superior for so long, it has deteriorated the relationship between stock prices and earnings due to the lack of confidence in the validity and recurrence of the recorded 'earnings.' If earnings are no longer a trusted predictor of future success, not only will investors be at a loss for how to evaluate options, but the utility of the accounting function and profession itself would decline. This would also widen the gap between investors and financial markets by misleading those who are less knowledgeable about the implications of earnings reporting, which is counteractive to the SEC's goals.

Finally, the application of the balance-sheet model has many problems including 'mark-to-market' and the less obvious impact that a 'feedback loop' between the financial markets and the real economy could have. If market prices (produced by financial markets) are viewed as the gold standard for valuation, the real or fundamental value (produced by the real economy) could be overlooked even when more reliable. The major issue here is the 'independent check' function of accounting which separates the accounting function from the financial markets and allows for them to influence but not control one another. The author clarifies that this is an oversimplification of the idea, but it demonstrates the danger that the balance-sheet approach could pose.

In conclusion, the author offers suggestions for a better conceptual framework. It is noted that the definition of ‘better’ is taken from the perspective of the outside investor. The first feature discussed is a better separation between operating and financing activities which would lead to more proper classification of assets and how they drive value which would then be reflected in all financial statements. Secondly, a shift to income statement approach relies on the emphasis of the matching and revenue recognition principles when dealing with operating activities. Accounting must be clear about these principles and have provisions and standards that align with and follow them. Revenue recognition is more straightforward, but the matching principle is where the income statement model derives its value, to get a clear picture of income, both the revenues and their matching expenses must be measured and linked to understand how the expenses drive the revenues. A major critique of the balance sheet approach was its failure to follow the business model and the matching and revenue principles directly correlate with how firm management and investors make decisions. These two suggestions aim to maintain the utility of accounting and financial reporting for the primary users and function of such reporting.

11.2 Questions

This article was incredibly interesting to read, not only because of the well-formed argument for income statement accounting, but also because it made me realize how much I understand about accounting and how my studies have prepared me for a career in this profession. When I started reading this article, it honestly had not

occurred to me that the way accounting and the conceptual framework is structured is based on the balance sheet as a superior reporting and valuation method. As we learn more and more about accounting, I have never considered the way that financial statements are structured or the hierarchy in which they are regarded. It was also very interesting to me that the FASB is the real reason for this model, however, the original argument made by the FASB did seem sound at first. I contemplated for a while how they might have come to this conclusion, what the current economic and accounting environment might have been at the time, and I would like to do some more research on this topic to learn more about the process. Obviously, the FASB was attempting to make the best decision possible and to provide a conceptual framework that would be long-lasting and beneficial to the accounting profession and users of financial information, but it is much easier to see these kinds of issue in hindsight and also in a changed economic light. As the article progressed through the four issues with the balance sheet approach, I was intrigued by the analysis because it is not so high level that an average person, or an average junior accounting major, could not understand. At first I was intimidated by the titles of the article contents, but through the examples, quantitative research, and broad analysis, it was very easy to see what the issues were and how they might have a significant impact. The first critique was most enlightening to me because I think it can be easy to get bogged down in the all the rules and standards of accounting but at the end of the day accounting is supposed to be the language of business and if the framework doesn't follow the same model and process that businesses use to evaluate their own performance and make decisions, then it isn't really doing its job. As I learn and process through accounting concepts, I want to be more conscious of the bigger picture and why certain rules are in place, what their function is in the world of business, and how they can be utilized to help make better decisions. This also showed me how important it is to continually evaluate what I am doing to ensure that it is the best possible solution and provides the proper output. I think we often blindly trust the standard setting body, but as discussed in the introduction, they value feedback and know that there are many insights that they might not have considered, so it is not only on the standard setting bodies but also on all of accounting professionals to maintain the utility and relevance of our craft. I also particularly liked that this article did not just bash the balance sheet approach and leave it at that, but they offered an insightful suggestion for how to move forward and be 'better.' I think this is also an important takeaway in that finding the problem is only half the analysis, you need to creatively solve and suggest a better way because that is how we move forward and become more successful.

I will definitely use this information in my career moving forward and be conscious of the impact that my work and analysis can have not just internally on the company, but on external investors and other financial statement users. I think it is very valuable to continually research and learn about why things are the way they are and evaluate their relevance and success. Accounting is not a self-contained process; it can have major impacts on outside parties and it is critical that we understand this impact and do not take that responsibility lightly. While it might not be immediately apparent, this article does contain an ethical component in its discussion of the way the financial market and real economy could be affected by these concepts. This reinforced for me the importance of always acting ethically in my role as an accounting professional.

Also, I think as an auditor our profession has progressed to be an even more analytical role and this article is proof that that can enact real change in this role. When evaluating the integrity and correctness of a company's financial statements it is not just about how well they follow the rules, because as this article demonstrated the rules don’t always create an accurate representation, so there has to be a bigger picture view of how useful the information is as a component of its correctness. By understanding this article and where the FASB is coming from, it could also be easier to connect with and understand older executives who have been following this approach for years. It is important to realize that the balance sheet approach does have some valid reasoning and might work for some businesses, so both approaches need to be compared and contrasted to choose the best one for the company. By fully comprehending both sides, we can create a more productive conversation with both sides. This might also require an explanation and some compromise with the company’s executives about which approach would be most beneficial to them. Change can be difficult, especially when one way seems to have been working in the past, but having this information has changed the way that I think about the accounting process and I believe it is important to share that if it will benefit my clients even though it might be difficult. Finally, I will take with me the creative solution and thorough explanation that the article offered as a model for problem solving. An issue was identified, explained in great detail with both qualitative and quantitative evidence, and then a feasible solution was presented while still acknowledging that it might not be perfect, and the conversation should continue. I think this is a great approach to take when solving a problem and one that I will carry with me through my career.

Google Inc. - Earnings Announcements and Information Environment

Prepared By: Caroline McLeod

April 24th, 2019

Table of Contents

12.1 Summary

This case is meant to expand upon an understanding of the purpose and content of managers' use of non-GAAP earnings and earnings guidance. In addition, the objective is to develop an understanding of the role that security analysts play in the firm's information environment. It is also important to analyze the timing of the release of earnings information to investors in addition to the type of information included in managers' quarterly press releases of financial information. Finally, there is an exploration of how investors respond to earnings and other information about a firm's performance.

This case was very interesting because I have not often looked at press releases or non-GAAP financial information. It really brought together the finance and investment sides of accounting. I also enjoyed making comparisons with stock prices and reported earnings because it showed how impactful financial reporting can be and how vital it is to conduct good audits. Lots of people rely on this information so it is important that we understand that impact.

12.2 Questions

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.

ii. 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 difference between GAAP income and non-GAAP income comes from the elimination of stock-based compensation expense and their related income tax effects, elimination of restructuring and related charges and their related income tax effects, and elimination of net loss from discontinued operations. These adjustments to arrive at non-GAAP income are meant to be more 'indicative of the recurring core business operating result' by excluding items that are non-cash or are discrete and infrequent so should not be used to predict future earnings, and particularly cash flows. This seems like a reasonable approach to give investors a view of the company from management's perspective. The adjustments are not meant to unrealistically inflate earnings, but to give the investors an operating result that is more comparable to other companies. However, if stock-based compensation is recurring and viewed as an operating expense, it should be included. There is also a very detailed explanation and rationale behind these adjustments that follows the guidelines of non-GAAP financial measures and their purpose.

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.

Google’s stock price jumped significantly after the Q3 earnings came out. Up until this point. This makes sense because Google’s overall earnings increased in 2013, and quarter three was the best quarter. However, there was still some volatility in the stock price after the year end earnings came out. The stock price very much mirrors the earnings of Google throughout 2013.

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).

The stock price of Google, while overall higher than the general NASDAQ index, follows the same trends throughout 2013. While there is a major jump in stock price for Google in Q3, after this initial jump the price continues to follow the general trend of NASDAQ index.

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.

On February 1st there is a large spike in stock price in response to the press release that details earnings. This would come from a market perception that Google’s future earnings and cash flows are going to continue to increase. The market shock did not last long and quickly went back down and then restored to a normal level of increase.

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?

Google's fourth quarter revenue was slightly higher than the analyst forecast, $16.8 billion was forecasted with$ 16.9 billion actually reported. It makes sense that Google's investors would be excited by them beating the earnings, but this major spike does not seem proportional to the revenue projection and actual numbers. The net earnings, however, were not as impressive on a GAAP reporting basis. The non-GAAP reported number did beat the predictions and this is where the stock jump likely resulted from because this number was more prominent in 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?

Other factors discussed in the article include the shift to internet usage on mobile phones instead of desktop computers and how it might impact advertising clicks and revenues. This could have caused major concerns about future performance, especially since the average amount received for each advertisement has steadily declined. This, however, did not seem to scare investors because Google did a good job of improving results for phones and demonstrating their commitment to this issue. Google has shifted to clickable ads with photos and prices that boosted their sales of and revenues from these ads. Investors are taking in all of the relevant information instead of just simple statistics without context.