A Study of Financial Accounting Principles through Analysis of Case Studies

John Parker Crane

University of Mississippi

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A Study of Financial Accounting Principles through Analysis of Case Studies

by
John Parker Crane

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

Advisor: Dr. Victoria Dickinson

Reader: Dr. Mark Wilder
ACKNOWLEDGEMENTS

Thank you to all of the people that made this thesis possible. My family has always supported me and pushed me to do my best. My professors in the Patterson School of Accountancy have gone above and beyond to provide me with a great education. They challenge me to reach my potential, and for that, I am grateful.
ABSTRACT
JOHN PARKER CRANE: A Study of Financial Accounting Principles through Analysis of Case Studies
(Under the direction of Victoria Dickinson)

This thesis is a compilation of twelve case studies performed throughout the 2018-2019 academic year under the direction of Dr. Vicki Dickinson. Each case study focuses on an aspect of the accounting world ranging from the current shift to data analytics to various financial accounting principles.
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Case 1: Data Analytics Case - Splunk

by: John Parker Crane

5 September 2018
Executive Summary

In this data analysis study, I delve into Splunk and its business uses. I learned what machine data is and how Splunk can transform it into relevant data. Splunk filters through machine data and make graphs, charts, and projection models based off of previously unstructured data. Splunk also offers many security and internal control options to better protect sensitive client data and detect threats inside and outside of a firm. I learned that Splunk would be useful in both the audit and tax practices through processes such as security and internal controls, data analysis, revenue tracking, and more.

Splunk would be a useful tool for an accountant. It could make work more efficient by lessening the amount of time spent on data analysis. Splunk’s simple interface would help accountants be able to quickly drag and drop data into tables and charts without having to learn any coding or going through extensive training. Splunk offers a way to turn unstructured machine data into new insights to help companies improve performance.

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

Splunk is a software that harnesses the power of machine data. Machine data is created by essentially everything connected to the internet from software applications to data servers to the internet of things. Machine data is unstructured data, but it can be used to offer business insights when properly organized. That is where Splunk enters the equation. Splunk captures this machine data and presents it in ways that can help businesses to better understand their IT and normal business operations. Splunk can create tables and graphs in real time to monitor activity in a company’s servers to track things from claim processing to customer behavior and geographic locations of sales to marketing campaign engagements. Splunk users do not need to
be technological experts. The interface is simple to navigate, and creating tables is as easy as dragging and dropping attributes into fields like a Microsoft Excel PivotTable. These tables provide businesses visual tools to keep up with the inner workings of the business in real time.

2. 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

Splunk could be used within a firm for internal audit controls and security. Splunk keeps track of user data including login/out times and any changes a user makes to the system. Splunk also can highlight anomalies to show where possible threats could be coming from and where possible system weakness may be. Splunk helps with alert management and risk analysis to keep information safe in today’s world rife with hackers.

Splunk can analyze large chunks of data quickly. Instead of sampling during an audit, Splunk could analyze all the activities taking place in a company’s ledger. This is impossible for auditors due to the amount of time it would take to investigate every transaction.

Splunk would also be useful in searching for anomalies in large chunks of data. An auditor could miss some errors during the audit, but Splunk could quickly process the data and present it in a way that flags possible errors to show the auditor exactly where he/she needs to take a deeper look.

B. Tax Planning

Splunk can also be useful for tax planning. Splunk can use geographic sales data to forecast future sales and help to estimate how much tax the company will have to pay dependent
on the tax rate in a particular state or country. Splunk could also identify regions which would result in the lowest taxation rate to help companies in multiple locations save on taxes.

Different types of revenues are taxed in different ways, and Splunk’s ability to separate these revenues into data sets and tables would be helpful to differentiate where revenue originated and how it should be properly taxed.

Splunk’s ability to quickly find anomalies in data sets could help firms identify the possibility of fraud in a company’s tax returns.

3. Write a few paragraphs to your future public accounting partner explaining why your team should invest in the acquisition of and training in this too. Explain how the tool will impact the staffing and scope of your future engagements.

To: Bob Jones, Partner
From: Parker Crane, Staff
Re: Data Analytic Investment

Splunk is a software that our firm should utilize. As the world shifts more and more into the Technology Age, it is important to not allow ourselves to be too slow to incorporate change and use newly available data. Splunk is a product that can improve our ability to intake large amounts of data and filter into useful ways. With Splunk Cloud we will be able to access our clients’ data from anywhere in the world, and our clients can similarly upload their data from anywhere. Instead of someone spending countless hours scouring through half usable data, Splunk will quickly sort the data into what we need.

Our audit and tax practices could be augmented by Splunk. With the security features offered by Splunk, we would be able to ensure that our clients’ information would be safe from threats both internal and external. We could see where threats could arise and snuff them out
before they become a problem. We also would be able to more efficiently perform audits as Splunk could search through data for anomalous transactions to help us more quickly pinpoint any mistakes or fraudulent activities. For tax purposes, Splunk could help us more easily present information to clients about geographic tax strategies and different forms of revenue being brought in by the client. The best part of Splunk is that all of this will be happening in real time. Instead of waiting long periods of time for data analysis or threat detection, Splunk can keep track of everything as it happens to help us be more proactive.

We will incur costs by purchasing Splunk and having to train employees to use it, but in the long run, Splunk will pay for itself. We will be able to perform audits and tax work more efficiently while also having better protection for our information. We can unlock new data usage to put our practice ahead of our competitors and offer next-level service to our clients.
Case 2: Rocky Mountain Chocolate Factory

by: John Parker Crane

12 September 2018
Executive Summary

In this case study, I made different types of journal entries from routine to adjusting to closing. I had to prepare trial balances, an income statement, and a balance sheet using cell referencing in Microsoft Excel. I learned how to format tables and use cell referencing to make financial statements.

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

I expect to see items such as cash, accounts receivable, PPE, inventory, accounts payable, wages payable, retained earnings, common stock, and additional paid-in capital on the balance sheet. The major assets would include cash, accounts receivable, inventories, and PPE. The major liabilities would be accounts payable and wages payable.

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

1) An adjusting entry for depreciation will be necessary.

2) There will probably be more accrued wages, or a payment of accrued wages.

3) An adjustment to inventory will also probably be needed.
### Pre-closing Trial Balance

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>1,253,947</td>
<td>4,100,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>4,229,733</td>
<td>3,743,092</td>
</tr>
<tr>
<td>Notes receivable, current</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Inventories</td>
<td>4,064,611</td>
<td>3,281,447</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>305,197</td>
<td>3,281,447</td>
</tr>
<tr>
<td>Property and Equipment, Net</td>
<td>4,535,598</td>
<td>3,281,447</td>
</tr>
<tr>
<td>Notes receivable, less current portion</td>
<td>124,452</td>
<td></td>
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<tr>
<td>Goodwill, net</td>
<td>1,046,944</td>
<td></td>
</tr>
<tr>
<td>Intangible assets, net</td>
<td>183,135</td>
<td></td>
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<tr>
<td>Other</td>
<td>4,535,598</td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>5,074,843</td>
<td>3,743,092</td>
</tr>
<tr>
<td>Accrued salaries and wages</td>
<td>423,789</td>
<td>3,281,447</td>
</tr>
<tr>
<td>Other accrued expenses</td>
<td>1,112,941</td>
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<tr>
<td>Dividend payable</td>
<td>598,986</td>
<td>0</td>
</tr>
<tr>
<td>Deferred income</td>
<td>142,000</td>
<td></td>
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<tr>
<td>Deferred income Taxes</td>
<td>22,000,000</td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td>1,499,477</td>
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</tr>
<tr>
<td>Additional paid-in capital</td>
<td>7,311,280</td>
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<tr>
<td>Deferred earnings</td>
<td>9,71,017</td>
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<tr>
<td>Sales</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Franchise and royalty fees</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Cost of Sales</td>
<td>14,000,000</td>
<td></td>
</tr>
<tr>
<td>Franchise costs</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Sales &amp; marketing</td>
<td>1,505,431</td>
<td></td>
</tr>
<tr>
<td>General and administrative</td>
<td>2,094,069</td>
<td></td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Income Tax Expense</td>
<td>0</td>
<td></td>
</tr>
</tbody>
</table>

### Unadjusted Trial Balance

A=L+OE+R-E = 3,580,077

### Adjusted Trial Balance

Dr. = Cr. = 0
Rocky Mountain Chocolate Factory  
Income Statement  
Year Ended Feb. 28, 2010

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>$ 22,944,017</td>
</tr>
<tr>
<td>Franchise and royalty fees</td>
<td>5,492,531</td>
</tr>
<tr>
<td><strong>Total Revenues</strong></td>
<td>$ 28,436,548</td>
</tr>
</tbody>
</table>

| **Costs and Expenses**       |                  |
| Cost of Sales               | 14,910,622       |
| Franchise costs             | 1,499,477        |
| Sales & marketing           | 1,505,431        |
| General and administrative  | 2,422,147        |
| Retail operating            | 1,756,956        |
| Depreciation and amortization | 698,580         |
| **Total Costs and Expenses**| $22,793,213      |

| **Operating Income**        | 5,643,335        |

| **Other Income (Expense)**  |                  |
| Interest Expense            | 0                |
| Interest income             | 27,210           |
| Other, net                  | 27,210           |

| **Income Before Income Taxes** | 5,670,545    |

| **Income Tax Expense**       | 2,090,468      |

| **Net Income**               | $ 3,580,077    |

| **Shares**                   |                  |
| Outstanding                  | 6,012,717       |

| **EPS**                     | $0.60           |
Rocky Mountain Chocolate Factory  
Balance Sheet  
February 28, 2010

**Assets**

**Current Assets**
- Cash and cash equivalents: $3,743,092
- Accounts receivable: 4,427,526
- Notes receivable, current: 91,059
- Inventories: 3,281,447
- Deferred income taxes: 461,249
- Other: 220,163

Total current assets: $12,224,536

**Property 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

**Stockholders' Equity**
- Common stock: 180,808
- Additional paid-in capital: 7,626,602
- Retained earnings: 6,923,927

Total stockholders' equity: 14,731,337

Total liabilities and stockholders' equity: $18,919,914
k. For each transaction, indicate whether the transaction would appear in the operating, investing, or financing section of the statement of cash flows.

<table>
<thead>
<tr>
<th>Transaction #</th>
<th>Cash Flows Section</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Operating</td>
</tr>
<tr>
<td>2</td>
<td>Operating</td>
</tr>
<tr>
<td>3</td>
<td>Operating</td>
</tr>
<tr>
<td>4</td>
<td>Operating</td>
</tr>
<tr>
<td>5</td>
<td>Operating</td>
</tr>
<tr>
<td>6</td>
<td>Operating</td>
</tr>
<tr>
<td>7</td>
<td>Operating</td>
</tr>
<tr>
<td>8</td>
<td>Operating</td>
</tr>
<tr>
<td>9</td>
<td>Investing</td>
</tr>
<tr>
<td>10</td>
<td>Financing</td>
</tr>
<tr>
<td>11</td>
<td>N/A</td>
</tr>
<tr>
<td>12</td>
<td>Operating</td>
</tr>
<tr>
<td>13</td>
<td>Operating</td>
</tr>
<tr>
<td>14</td>
<td>Operating</td>
</tr>
<tr>
<td>15</td>
<td>N/A</td>
</tr>
</tbody>
</table>
Case 3: Musings on the Future

John Parker Crane

19 September 2018
Executive Summary

In this case, I examine my own views on common thought processes among accounting students and young professionals. Is going to law school for tax a better route? Is going into other business-related fields with an accounting degree a good decision? Is transferring between offices acceptable? On the surface, I believed these were quite simple questions, but I realized I was wrong after a discussion amongst classmates. These questions cannot be answered solely based on personal preference but must also include considerations for other people directly and indirectly involved in the process. This case made me think more deeply about the future and decisions that I should already be mulling.

1. A student is considering going to law school after undergraduate to study tax law as opposed to completing the Master of Taxation program. Is this a smart route?

I had never previously considered going to law school instead of graduate school for tax. Personally, I have no interest in law school. I have a very analytical brain, and because law school is based on readings and concepts, I do not believe that I would be successful there.

For others, however, law school may be a perfectly valid option. The disadvantages of going to law school are two additional years of schooling and schooling fees. These students would also be forfeiting two years of earning potential while taking on debt or paying for school. Advantages would also exist. Upon entering the workforce, the law students would demand a higher salary, but after a few years, the difference in salary between workers with a J.D. and an M.Tax. become negligible. The University of
Mississippi has a concurrent program that allows students to earn both a J.D. and an M.Tax. in less time than it would take to earn both degrees separately. This would be my suggestion to a student considering the path to law school because the program offers the career opportunities associated with both degrees.

Our class discussion also addressed the topic of whether the student considering law school should be transparent with firms that are recruiting him or her. The answer is yes. Firms allocate a lot of resources to recruiting and training incoming students. If the student is planning on going through law school and not working for the firm upon completion, he or she should let the firm know this because it affects the firm as well as future students from the school who may no longer have a slot available to them because someone burned the firm previously. Transparency is always the best policy. If he or she is a good enough student, the firm may stick their neck out and take a chance anyway.

2. **An accounting student is doing an accounting internship but plans on working in investment banking long-term. Is this student in the wrong?**

Like the previous answer, taking a slot for an internship and leaving the firm for other opportunities hurts the school and future students’ prospects of working in that particular office. This student should be up front with the firm about his or her plans to work in investment banking long-term. That does not mean the student cannot work for the firm short-term which could be a win-win situation for both parties.

For me, the greater question here is if it is acceptable to work in other sections of the business world with an accounting degree. I believe it is acceptable, but one should probably start working in the public accounting world because it is very difficult to move back into public accounting after leaving for a different business profession. My personal
dream is not to be an accountant. I want to work in sports business for a professional sports team. After discussion with the class and Dr. Dickinson, I now believe that I should work in public accounting for a time and attempt to parlay success in that field into a job opportunity in the sports business world instead of immediately trying to enter the sports business realm. I can help a firm while pursuing my long-term goal by working in a location and with a firm that works closely with a sports team. I can build relationships in the sports business world which could open future doors for me all while providing the value of my work to the firm.

3. A student has completed his or her internship in Washington, D.C. with a job offer. The student would like to transfer the offer to Dallas because he or she would prefer working in his hometown. Is this behavior acceptable?

It is common for internships to culminate with job offers in the same office as the internship. That office recruited and trained the intern and therefore has incurred costs related to the intern. It is logical for the office to want to recuperate that investment by hiring the intern full-time (assuming the intern is capable). Each office only has so many available positions, so transferring to a different office upon hiring is a difficult proposition.

If the student knew that he would probably opt to return home as opposed to accepting full-time in Washington, D.C., he should have informed the firm to this possibility. The student should accept the position in Washington, D.C. and work for a time before exploring opportunities to transfer offices. During discussion, the uncertainty regarding the student’s circumstances was brought up, and I should note that under dire
circumstances (e.g. family issues) it is acceptable to inform the firm of the circumstances and ask for the transfer.

Discussion also brought up whether it was acceptable for the student to reach out to Dr. Dickinson for advice. I have no issue with the student asking a respected figure in his life for advice, but there is a line as to what he can ask. He must realize that Dr. Dickinson has responsibilities to her employer, future students, and relationships within that firm that she must weigh. He must step up and talk to the partner at the firm. He cannot expect Dr. Dickinson to do this for him.
Case 4: Generic Bank

John Parker Crane

3 October 2018
Executive Summary

In this case, I look into impairment losses on available for sale securities for Generic Bank. Generic Bank has a large portfolio of debt securities. The securities are reported at fair value with any changes in the fair value being disclosed in Accumulated Other Comprehensive Income as Unrealized Holding Gains/Losses. The overarching question of this case is whether or not these unrealized holding losses should be recognized as impairment losses and thus be placed into net income. I had to research what an impairment loss is and what requirements a debt security must meet in order to be deemed impaired. By reading through regulations published by FASB, the Federal Reserve, and the Office of the Comptroller of the Currency, I was able to determine whether or not the securities that the bank held were impaired. Different scenarios and circumstances were presented to highlight the intricacies of accounting for debt securities.

Through this case, I learned how to do accounting research through FASB and other regulating entities. I learned how banks do business and what a debt security is. I learned what impairment is and what the various requirements a security must meet to be impaired.

1. Assume that Generic Bank does sell the aforementioned securities shortly after year end in early 20x3. Does Generic Bank have an impairment loss on the seven securities designated above in 20x2?

Generic Bank does have an impairment loss on the seven designated securities in 20x2. The seven designated securities are all classified as available for sale securities which have a two-step process for determining impairment. To assess impairment on available for sale debt securities the bank must first determine if the decline in value is related to credit losses. In this case Generic Bank believes that the declines in value are not related to credit losses but rather interest
rate changes. This leads to the second assessment of impairment. If the bank can assert that it has the intent and ability to hold the securities until the securities can recover to the amortized cost basis, then the securities are not classified as impaired.

Generic Bank is claiming to have the intent to hold onto their available for sale securities until the fair values return to the amortized cost. However, the case states that Generic Bank’s CFO is considering selling some available for sale securities to free up cash for employee bonuses and strategic acquisitions in early 20x3. The CFO identified seven securities to sell before the end of 20x2. The sale did not occur until early 20x3, but because the CFO had already identified the securities in 20x2, the bank lost the intent to hold the securities until the loss could be recovered. Therefore, the seven securities should be impaired in 20x2.

Two of the seven securities (CUSIPs 067 and 096) are unrealized holding gains, so these cannot be recognized in the net income of 20x2 because the gain was not yet realized. The five securities in an unrealized holding loss position should be recognized in 20x2’s net income because the impairment loss occurred in 20x2 when the CFO lost the intent to hold the securities until the loss could be recovered.

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

   Based on the information given in the case, Generic Bank does not have an impairment loss on any of the securities not included in the seven that were sold. Once again, the two-step impairment test comes into play. The securities are not affected by credit deterioration,
and the bank still asserts that it has both the ability and intent to keep the securities until the unrealized holding loss is recovered.

CFO Winters is concerned about how the securities sale impacts the bank’s assertions of intent and ability to hold the other securities, but ASC 326-30-35-4 states that “impairment shall be assessed at the individual security level” meaning that the sale of the seven securities should not affect any of the remaining ninety-three securities. Also concerning the bank’s intent, ASC 326-10-35-33B states that if an entity assesses that it is “more likely than not be required to sell the security before recovery of its amortized cost basis” for reasons including meeting regulatory obligations. Because the bank is “well capitalized,” it is in no danger of needing to sell the securities before the securities can recover the amortized cost basis. Therefore, the bank’s intent has not been compromised by the sale of the seven securities.

Also, the bank must consider both the length of time and extent to which a security is in an unrealized holding loss position. At a certain point, an impairment loss should be recognized. The bank, however, can determine what point in time or to what extent of loss the securities become impaired, so they do not necessarily have to recognize any impairment losses.

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?

My answer does not wholly change if my role changes. I believe both the external auditor and bank regulator should approach this case with skepticism. Generic Bank is making assertions that the auditor and regulator should investigate for affirmation. The first thing that
must be confirmed is that the changes in fair value are not credit related. Afterwards, the capitalization of the bank should be checked to make sure that the bank is not in danger of failing to meet regulation standards. Assuming both assertions can be proven, the accounting should not change from what has been previously stated. The intent to sell the seven securities can be surmised to have occurred in 20x2, and therefore an impairment loss should be recognized for the five securities in an unrealized holding loss position. The decision to sell the seven securities does not affect the intent related to the remaining ninety-three securities, so they should remain in an unrealized holding gain or loss position as long as the bank is well capitalized.

One more factor that must be checked is the bank’s assertion that the securities will recover to the amortized cost. If the security is not expected to fully recover, an impairment loss should be recognized for the value of the amortized cost less the expected recoverable amount. The bank asserts that the securities will recover to amortized cost, but the bank should provide details to prove this assertion as well as an estimated time period in which the recovery will occur. As an external auditor, I would be especially suspicious in regard to the securities that have been in a continuous unrealized loss position for greater than twelve months and securities with fair values significantly less than amortized costs. The OCC states that “the length of time and the extent to which the fair value has been less than the amortized cost basis.” I would be more likely to assess impairment losses on securities that have been in loss positions for long periods of time and/or are in particularly high percentage loss positions.
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?

I would be suspicious if the seven sold securities were in a net gain position. Seven securities in a net gain position would not accurately represent the security portfolio as a whole considering the portfolio shows a net unrealized holding loss position of nearly $430 million. Selling a group of selected securities at a net gain when the portfolio is in a large net unrealized holding loss position makes me question if the bank is faithfully representing their portfolio. It would appear that the bank would be trying to cover up loss on some securities by making the overall transaction have a net gain. I would be more likely to assess that impairments have occurred.

If each of the sold securities was in a gain position, I would go the opposite way. If the bank is only selling securities in a net gain, I would be more inclined to believe their assertion of having the intent to hold on to securities in an unrealized holding loss position until the amortized cost could be recovered. I would therefore be less likely to assess an impairment.

5. Assume that Generic Bank does sell the aforementioned securities shortly after year end in early 20x3. Does Generic Bank have an impairment loss on securities other than the seven securities sold?

Yes, Generic Bank does have an impairment loss on other securities. The bank previously had some leeway because they were well capitalized and could reasonably assert that they had both the intent and the ability to hold securities until the loss was recovered. However, now that the bank is only adequately capitalized with less borrowing options to meet liquidity regulations, the assertion that the bank has the ability to hold the securities is less believable. The bank also
desires to sell securities to improve capital ratios which hurts the assertion of intent. Therefore, the bank should recognize impairment losses on many of their securities.
Case 5: Cities

John Parker Crane

7 November 2018
Executive Summary

In this case, I consider two potential cities in which to start my professional career. My long-term goal is to work in the business of sports, so it would behoove me to be in a city with professional sports teams. I also would like to stay semi-close to Mississippi and my family. Therefore, I selected Washington D.C. and Atlanta for their location and the availability of sports teams.

I have visited Washington a couple of times and love the city. After researching the city, I see that the city is slightly more dangerous than I thought. Washington also has a higher cost of living than I expected. The city is still very attractive to me, though.

Atlanta is considerably closer to home and significantly cheaper. Atlanta traffic is the main deterrent for the city, but by living within two miles of each Big Four’s office negates the traffic.

After doing this case, I still believe I would like either city, but Atlanta is certainly the more enticing option.
Questions

1. What is the population?
2. Describe the climate and seasonal fluctuations.
3. Describe the city’s topography, scenery, and other geographic or geological features of the area in which the city is located.
4. What are the individual tax rates within the city?
5. What transportation hubs are in the city?
6. What are the city’s most prevalent industries?
7. Describe the quality of the city’s healthcare.
8. What types of crime are common within the city and where are the locations within the city to avoid?
9. Based on where you see yourself living for the first three years, how much rent do you expect to pay?
10. What is the typical mode of commuting? What are your likely commute times?
11. Where will you do your grocery shopping?
12. How will you do your laundry?
13. Name at least three civic, religious, or charitable organizations you would like to be active in for each city.
14. 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.
15. What are the modes of traveling back to your hometown from this city? What is the average cost you’d incur for each trip back home?
City 1: Washington D.C.

1. City: 703,608  
   Metro Area: 6.1 million

2. The climate is pretty similar to that of Mississippi. The summers are milder and winters colder in D.C. plus distinct fall and spring seasons. D.C. also gets about 41 inches of precipitation a year.

3. Washington D.C. is nestled between Virginia and Maryland along the Potomac River. It is a flat place at sea level, but what it lacks in hills and valleys, it more than makes up for in architecture. D.C. is full of classic architecture and many monuments and governmental buildings. The city offers a lot of beautiful scenery, most notably the National Mall.

4. Local tax rate: $2,200 + 6.5% of the excess over $40,000
   
   Federal tax rate: 22% (13.88% effective)
   
   Property tax rate: $0.85 per $100
   
   Sales tax rate: 5.75%
   
   Gas tax rate: 23.5 cents/gal

5. Washington D.C. has both a bus and train system known as MetroBus and MetroRail respectively that run to parts of surrounding Maryland and Virginia.
6. Government is the largest industry in Washington D.C. Education and tourism are also large industries in D.C.

7. The quality of healthcare in D.C. is very high with George Washington University Hospital in the city and Johns Hopkins Hospital nearby. The cost of healthcare is higher due to the quality and demand.

8. The crime rate in Washington D.C. is significantly higher than elsewhere in the country. There is a lot of robbery, assault, theft, and vehicle theft in Washington D.C. Places to avoid include Washington Highlands, NoMa, Columbia Heights, Deanwood, and Brentwood.

9. A one bedroom apartment in Washington D.C. costs $1,500 to $2,000. For $1,675 a month, I could get an apartment in the Shaw area. This apartment is only a few blocks away from a Metro station. It is 650 square feet with shared laundry. There is no data on parking, but there does not appear to be any parking available.
10. The apartment in Shaw is near a Metro station. I could walk the few blocks to the station and take a train to work. The commute to each of the Big Four firms would take less than twenty minutes.

11. There are multiple grocery stores nearby in D.C. including ABC Grocery, Grape Hop Market, Giant Food, and more.

12. The apartment I have selected offers laundry, so I would do laundry at home.

13. I would attend Grace Presbyterian Church in nearby Mount Vernon Triangle. I love soccer and would love to get involved in refereeing youth soccer in the D.C. area. There are many different soccer clubs in the area with which to get involved including the D.C. United Youth Academy. I would also volunteer at SOME (So Others Might Eat). I have volunteered at SOME once before on a trip to D.C., and it was a good experience and a good way to serve the community.

14. One of the major draws to D.C. for me is the sports. I would probably get season tickets for D.C. United because I love soccer. I would also attend Nationals games (especially when my beloved Cubs are in town), Wizards games, and Redskins games. Outside of sports, D.C. has a great entertainment scene with Capital One Arena being a common concert arena and a good theatre scene as well. I also love comedy, and D.C. has multiple comedy clubs that I would probably frequent.

15. Traveling home would be a flight from D.C. to Jackson. Around Christmas time, a roundtrip ticket can get up to nearly $800, but by leaving a little earlier and/or leaving a little later, tickets can get down to around $300. A typical roundtrip ticket from D.C. to Jackson runs at about $300.
City 2: Atlanta

1. City: 486,290  
   Metro Area: 5.8 million

2. Atlanta has a typical southern climate with hot, muggy summers and short, wet winters.  
   Atlanta gets nearly 50 inches of precipitation per year.

3. Atlanta is located atop a ridge south of the Chattahoochee River.  The city offers a high-rise skyline.  Atlanta has more expressive, modern architecture than most southern cities.  
   Just 30 minutes outside of town is Stone Mountain.

4. State tax rate: 6%  
   Federal tax rate: 22% (13.88% effective)  
   Property tax rate: Depends on property value, 0.93% on average  
   Sales tax rate: 8.9%  
   Gas tax rate: 31.09 cents/gal

5. MARTA is Atlanta’s public rail and bus system but is not the most convenient system.  
   Atlanta is building a BeltLine that will connect 45 in town neighborhoods through trails and streetcars making transportation more accessible.

6. Financial Services, technology, and telecommunications are the largest industries in Atlanta.
7. Healthcare in Georgia is not the highest quality, but Atlanta is a solid city with Emory University Hospital.

8. Atlanta’s crime rate is also significantly higher than the national average. Robbery, assault, burglary, theft, and vehicle theft are common types of crime. Downtown, Kirkwood, Castleberry Hill, and Washington Park are places to avoid.

9. Living in Atlanta is cheaper than living in Washington D.C. A one bedroom in Midtown costs from $900 to $1,600 a month. I found a nice, private place for $995 a month with 700 square feet, shared laundry, utilities, and street parking.

10. Currently, the most used form of commuting in Atlanta is by car. Each Big Four firm has an office within two miles of Midtown which would be a less than ten minute drive or a nearly twenty minute walk.

11. There is an L&M Service Market two blocks from the apartment on Penn Avenue. There are also four other grocery stores within a mile of the apartment.

12. The apartment I have selected offers laundry, so I would do laundry at home.

13. In Atlanta, I would attend the nearby Ponce Presbyterian Church. I would still be interested in working in youth soccer, and there are many youth clubs in the area.
including the Atlanta United Youth Academy. I would also be interested in serving with Warrick Dunn Charities. Warrick Dunn is a former NFL football player who constructs houses for less fortunate families through his charity. It is a similar project to the more commonly known charity Habitat for Humanity.

14. The sports in Atlanta are also a huge draw for me. I would like season tickets to Atlanta United games, and I would also love to attend Falcons, Braves, and Hawks games.

Atlanta has a great music scene as the hip-hop capital of the United States. Atlanta also has many comedy clubs and theatres that I would visit regularly.

15. If I lived in Atlanta, driving home to Pearl would be an option. It is about a six-hour drive at 379 miles. My car gets 32 miles per gallon on the interstate. Assuming gas is $2.50 per gallon, I would have to pay around $60 for gas. I would probably more commonly fly home. A roundtrip flight from Atlanta to Jackson is around $275 during Christmas time and a little under $200 during the rest of the year.
16. Budgets:

<table>
<thead>
<tr>
<th>Washington DC</th>
<th>Atlanta</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Income</td>
<td>$ 5,000.00</td>
</tr>
<tr>
<td>Taxes:</td>
<td></td>
</tr>
<tr>
<td>Federal 694</td>
<td>Federal 694</td>
</tr>
<tr>
<td>State 292</td>
<td>State 300</td>
</tr>
<tr>
<td>FICA 310</td>
<td>FICA 310</td>
</tr>
<tr>
<td>Medicare 72.50</td>
<td>Medicare 72.50</td>
</tr>
<tr>
<td><strong>Total:</strong> 1368.17</td>
<td><strong>Total:</strong> 1376.50</td>
</tr>
<tr>
<td>Net Income 3,631.83</td>
<td>Net Income 3,623.50</td>
</tr>
<tr>
<td>Rent 1,675.00</td>
<td>Rent 995.00</td>
</tr>
<tr>
<td>Health Insurance 350.00</td>
<td>Health Insurance 350.00</td>
</tr>
<tr>
<td>Food 300.00</td>
<td>Food 300.00</td>
</tr>
<tr>
<td>Travel 200.00</td>
<td>Travel 200.00</td>
</tr>
<tr>
<td>Phone Bill 50.00</td>
<td>Phone Bill 50.00</td>
</tr>
<tr>
<td>Entertainment 200.00</td>
<td>Entertainment 200.00</td>
</tr>
<tr>
<td><strong>Savings</strong> 856.83</td>
<td><strong>Savings</strong> 1,528.50</td>
</tr>
</tbody>
</table>

17. After this analysis, I am still interested in both cities. I would select Atlanta over D.C.

The cost of living in Washington is higher than in Atlanta, and Atlanta is closer to home.

I could be happy in either, but I believe Atlanta would be the better option.
Case 6: WorldCom, Inc.

John Parker Crane

16 November 2018
Executive Summary

In this case, I reviewed WorldCom, Inc. and considered the ramifications of wrongfully capitalizing costs. WorldCom capitalized line costs related to fees paid to local telecommunications service providers which would insinuate that WorldCom owned these lines. However, WorldCom did not own these lines and should have expensed the costs as incurred instead of over time through depreciation.

I had to examine financial statements and deduce what types of improper journal entries were made by WorldCom. After this, I had to recalculate the net income for the affected year to see what kind of affect improper capitalization can have on an income statement. I found that the income statement was greatly affected and learned how large the impact of improper capitalization can be.

a. FASB Statement of Concepts No. 6, *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.”

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

i. Asset – things a company owns/has rights to

ii. Costs should generally be expensed when immaterial or short-term. Costs should be capitalized when they can be expected to be consumed over a long period of time or lead to future cash flows.
b. **What becomes of “costs” after their initial capitalization?** Describe, in general terms, how the balance sheet and the income statement are affected by a decision to capitalize a given cost.

After initial capitalization, costs are usually either depreciated or amortized over time. Non-capitalized costs are expensed in the period in which they are incurred and lower net income for that period. Capitalized costs are viewed as assets and depreciate over multiple periods slightly lowering net income each period.

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.

WorldCom reported line costs of $14.739 billion in 2001. I define these line costs as fees paid to owners of telephone lines for the right to utilize the lines.

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?

According to the *Wall Street Journal* article, the improperly capitalized line costs were “charges paid to local telephone networks to complete calls.” These are simple expense transactions paid to local telecommunications service providers. These costs do not meet the definition of an asset because the company does not own these lines. If the company was building their own network of lines, the story would be different. However, paying
for the right to use the asset of another company does not give WorldCom the right to claim the asset as their own.

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?**

Transmission Equipment $3,055,000,000

| Line Costs          | 3,055,000,000 |

These costs appeared in Property and Equipment on the balance sheet and in capital expenditures 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.**

\[
\frac{771}{22} + .75\left(\frac{610}{22}\right) + .5\left(\frac{743}{22}\right) + .25\left(\frac{931}{22}\right) = 83,306,818
\]

**Depreciation Expense** $83,306,818

**Accumulated 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% 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?

<table>
<thead>
<tr>
<th>2001 (numbers in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income</td>
</tr>
<tr>
<td>Adjustments (net of tax):</td>
</tr>
<tr>
<td>Line Cost Correction</td>
</tr>
<tr>
<td>Depreciation Correction</td>
</tr>
<tr>
<td>Total Adjustment</td>
</tr>
<tr>
<td>Net Income (Corrected)</td>
</tr>
</tbody>
</table>

The net income is very much materially affected. The reported net income was $1.5 billion and is a loss of $431 million after being corrected. I assumed that the minority interests remained the same as reported because I saw no correlation in the previous years to be able to calculate a new figure.
Case 7: Starbucks Corporation

John Parker Crane

6 March 2019
Executive Summary

For this case I had to look into the financial statements of Starbucks Corporation. I had to identify and define the nature of Starbucks business as well as various accounting procedures, accounts, and financial statements that they use. I had to read through audit opinion papers to learn what the auditors determined during the span of their audit. I used Microsoft Excel to change Starbucks’ consolidated financial statements into common-size statements. I learned that common-size income statements present data as a percentage of net revenues and common-size balance sheets present data as a percentage of total assets. I analyzed the Starbucks financial statements to find things such as how the company divides its assets, how the company is financed, and what accounts are important for the company. I also learned how Starbucks recognizes revenue in the various channels of their business.

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

Starbucks is a food and beverage business. It sells various foods and beverages in both its own shops and outside retailers.

b. What financial statements are commonly prepared for external reporting purposes?

What titles does Starbucks give these statements? What does “consolidated” mean?

Commonly prepared external reporting financial statements include the income statement, balance sheet, statement of cash flows, and statement of stockholders’ equity. The titles Starbucks gives these statements are: consolidated statements of earnings, consolidated balance sheets, consolidated statements of cash flows, and consolidated statements of equity,
respectively. Starbucks uses the term “consolidated” because multiple years of financial data are shown for comparison purposes.

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

Publicly traded corporations typically prepare financial statements quarterly (10-Q), yearly (10-K), and when significant financial events occur (8-K).

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

Starbucks’ management is responsible for the financial statements. Potential users of these statements include analysts, investors, and shareholders. These people are likely most interested in earnings per share, dividend yield, profitability ratios, debt, and risk factors.

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

Deloitte is Starbucks’ external auditor. The two opinion letters state that Starbucks’ financial statements and internal controls are materially correct and acceptable according to the standards set forth by the PCAOB. These opinions are dated after Starbucks’ year-end because an audit takes time to perform in order to thoroughly inspect a company’s financial statements and internal controls.
f. Use a spreadsheet to construct common-size income statements and balance sheets for 2013 and 2012.

<table>
<thead>
<tr>
<th>Consolidated Statements Of Earnings (USD $) Common Size</th>
<th>12 Months Ended</th>
</tr>
</thead>
<tbody>
<tr>
<td>In Millions, except Per Share data, unless otherwise specified</td>
<td>Sep. 29, 2013</td>
</tr>
<tr>
<td><strong>Net revenues:</strong></td>
<td></td>
</tr>
<tr>
<td>Company-operated stores</td>
<td>79.19%</td>
</tr>
<tr>
<td>Licensed stores</td>
<td>9.14%</td>
</tr>
<tr>
<td>CPG, foodservice and other</td>
<td>11.67%</td>
</tr>
<tr>
<td>Total net revenues</td>
<td>100.00%</td>
</tr>
<tr>
<td><strong>Cost of sales including occupancy costs</strong></td>
<td>42.86%</td>
</tr>
<tr>
<td>Store operating expenses</td>
<td>28.78%</td>
</tr>
<tr>
<td>Other operating expenses</td>
<td>3.07%</td>
</tr>
<tr>
<td>Depreciation and amortization expenses</td>
<td>4.17%</td>
</tr>
<tr>
<td>General and administrative expenses</td>
<td>6.30%</td>
</tr>
<tr>
<td>Litigation charge</td>
<td>18.70%</td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>103.87%</td>
</tr>
<tr>
<td>Gain on sale of properties</td>
<td>0.00%</td>
</tr>
<tr>
<td>Income from equity investees</td>
<td>1.69%</td>
</tr>
<tr>
<td>Operating income</td>
<td>-2.19%</td>
</tr>
<tr>
<td>Interest income and other, net</td>
<td>0.83%</td>
</tr>
<tr>
<td>Interest expense</td>
<td>-0.19%</td>
</tr>
<tr>
<td>Earnings before income taxes</td>
<td>-1.54%</td>
</tr>
<tr>
<td>Income taxes</td>
<td>-1.60%</td>
</tr>
<tr>
<td>Net earnings including noncontrolling interests</td>
<td>0.06%</td>
</tr>
<tr>
<td>Net earnings attributable to noncontrolling interest</td>
<td>0.00%</td>
</tr>
<tr>
<td>Net earnings attributable to Starbucks</td>
<td>0.06%</td>
</tr>
<tr>
<td>Earnings per share - basic</td>
<td>$0.01</td>
</tr>
<tr>
<td>Earnings per share - diluted</td>
<td>$0.01</td>
</tr>
<tr>
<td><strong>Weighted average shares outstanding:</strong></td>
<td></td>
</tr>
<tr>
<td>Basic</td>
<td>749.3</td>
</tr>
<tr>
<td>Diluted</td>
<td>762.3</td>
</tr>
<tr>
<td>Cash dividends declared per share</td>
<td>$0.89</td>
</tr>
</tbody>
</table>
## Consolidated Balance Sheets
(USD $)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>In Millions, unless otherwise specified</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Current assets:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>22.36%</td>
<td>14.46%</td>
</tr>
<tr>
<td>Short-term investments</td>
<td>5.71%</td>
<td>10.32%</td>
</tr>
<tr>
<td>Accounts receivable, net</td>
<td>4.87%</td>
<td>5.91%</td>
</tr>
<tr>
<td>Inventories</td>
<td>9.65%</td>
<td>15.10%</td>
</tr>
<tr>
<td>Prepaid expenses and other current assets</td>
<td>2.50%</td>
<td>2.39%</td>
</tr>
<tr>
<td>Deferred income taxes, net</td>
<td>2.41%</td>
<td>2.90%</td>
</tr>
<tr>
<td>Total current assets</td>
<td>47.51%</td>
<td>51.09%</td>
</tr>
<tr>
<td>Long-term investments</td>
<td>0.51%</td>
<td>1.41%</td>
</tr>
<tr>
<td>Equity and cost investments</td>
<td>4.31%</td>
<td>5.60%</td>
</tr>
<tr>
<td>Property, plant and equipment, net</td>
<td>27.79%</td>
<td>32.35%</td>
</tr>
<tr>
<td>Deferred income taxes, net</td>
<td>8.40%</td>
<td>1.18%</td>
</tr>
<tr>
<td>Other assets</td>
<td>1.61%</td>
<td>1.76%</td>
</tr>
<tr>
<td>Other intangible assets</td>
<td>2.39%</td>
<td>1.75%</td>
</tr>
<tr>
<td>Goodwill</td>
<td>7.49%</td>
<td>4.86%</td>
</tr>
<tr>
<td><strong>TOTAL ASSETS</strong></td>
<td><strong>100.00%</strong></td>
<td><strong>100.00%</strong></td>
</tr>
<tr>
<td><strong>Current liabilities:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>4.27%</td>
<td>4.84%</td>
</tr>
<tr>
<td>Accrued litigation charge</td>
<td>24.17%</td>
<td>0.00%</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>11.02%</td>
<td>13.79%</td>
</tr>
<tr>
<td>Insurance reserves</td>
<td>1.55%</td>
<td>2.04%</td>
</tr>
<tr>
<td>Deferred revenue</td>
<td>5.68%</td>
<td>6.21%</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>46.69%</td>
<td>26.89%</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>11.28%</td>
<td>6.69%</td>
</tr>
<tr>
<td>Other long-term liabilities</td>
<td>3.11%</td>
<td>4.20%</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>61.08%</td>
<td>37.77%</td>
</tr>
</tbody>
</table>

### 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) | 0.01% | 0.01%
- Additional paid-in capital | 2.45% | 0.48%
- Retained earnings | 35.86% | 61.40%
- Accumulated other comprehensive income | 0.58% | 0.28%
- Total shareholders' equity | 38.90% | 62.16%
- Noncontrolling interests | 0.02% | 0.07%
- Total equity | 38.92% | 62.23%
- **TOTAL LIABILITIES AND EQUITY** | **100.00%** | **100.00%**

43
g. Refer to Starbucks’ balance sheet for fiscal 2013.

i. Demonstrate that the accounting equation holds for Starbucks.

\[ 11,516.7 = 7,034.4 + 4,482.3 \]
\[ 11,516.7 = 11,516.7 \]

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

Cash, inventory, and PPE are the major assets of Starbucks. Current assets made up 47.51% of total assets with long-term assets making up the remaining 52.49%. This seems appropriate for Starbucks. Owning property is a smart decision because land will always have value even if the coffee business goes under. The nature of selling goods means that there will also be a large amount of assets tied up in inventory, cash, and accounts receivable.

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

An intangible asset is a non-physical asset. Goodwill is the intangible asset that arises when buying a company and the purchase price is greater than the fair value of the company. Specific intangible assets that Starbucks may have include copyrights, trademarks, goodwill, and franchises.
iv. How is Starbucks financed? What proportion of total financing comes from non-owners?

Starbucks is financed through common stock, additional paid-in capital, retained earnings, and debt. Because of the litigation liability, the 2013 debt-equity ratio is significantly affected. The years 2012 and 2013 show that retained earnings make up the most significant portion of the liabilities and equity’s section. In 2013 Starbucks took on more long-term debt along with the litigation charge liability. Of total financing, 61.08% comes from non-owners.

h. Refer to Starbucks’ statement of earnings for fiscal 2013 and to the common-size income statement in part f above

i. Does Starbucks record revenue when they receive cash from their customers or do they follow a different rubric? How does Starbucks record revenue on stored value cards? What challenges in measuring revenue do you observe? That is, are there any significant judgments management needs to make in recording sales revenues at Starbucks?

Starbucks uses accrual accounting to recognize revenue. Revenue from stored value cards is recognized either when the card is used or when it is deemed that the card is unlikely to be used. Starbucks earns revenue in different areas, so it is may be difficult to understand when revenue can be recognized. For licensed stores revenue is recognized upon shipment, but for foodservice revenue is recognized upon receipt by the customer or distributor. Recognition of revenue from stored value cards is also difficult because it is hard to determine whether a stored value card will be redeemed. Management has to
make significant judgements with stored value cards and Starbucks rewards cards because these two things affect deferred revenue and can be recognized per management’s decision.

ii. What are Starbucks’ major expenses?

Starbucks major expenses include cost of sales, store operating expenses, and general and administrative expenses.

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

In the most recent year a nearly $3 billion litigation charge was incurred.

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

The litigation charge was not included in general and administrative expenses because of how large the charge is. It stands alone because it is nearly $3 billion. It is listed as an operating expense because the lawsuit derived from operations.

v. Was the company profitable during 2013? During 2012? Explain your definition of “profitable.”

The company was not profitable in 2013 but was profitable in 2012. My definition of “profitable” is having a positive operating income.
i. Refer to Starbucks’ fiscal 2013 statement of cash flows.

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

The net earnings in 2013 were $8,800,000 while the net cash provided by operating activities was $2,908,300,000. The reason for the large difference is the litigation charge. Because it had not been paid as of September 29, 2013, the charge is classified as a noncash expense. As such, the charge decreases net income while not affecting cash flows.

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

Starbucks used $1,151,200,000 on expenditures for PPE during 2013.

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

Starbucks paid $628,900,000 in dividends during the year. This amount is less than the amount reported on the statement of equity. Starbucks’ financial statements show a pattern of declaring more dividends than they pay each year which results in an increase to a current liability account.

j. Several notes to the financial statements refer to the use of “estimates.” Which accounts on Starbucks’ balance sheet require estimates? List as many accounts as you can. Are any accounts estimate-free?

Many of Starbucks’ accounts require estimates including: short-term investments, net accounts receivable, inventories, prepaid expenses, net PPE, other intangible assets, goodwill, accrued
litigation charge, and insurance reserves. Cash, long-term debt, accounts payable, accrued liabilities, and equity accounts are estimate-free.
Case 8: BP p.l.c – Contingencies

John Parker Crane

3 April 2019
Executive Summary

This case primarily deals with the 2010 Deepwater Horizon BP oil spill and the accounting that was done afterwards pertaining to contingent liabilities. BP knew that the spill would have a large financial impact on the company but had no way of knowing exactly what the effect would be. The company still had to release financial statements, though, and had to figure some way to account for the expected losses. I learned that these losses are usually accounted for in a contingent liability account, but in this case, determining the probability of incurring a loss and an estimate of said loss was nearly impossible. I learned that management needed to consider many different factors when trying to determine what losses would look like including regulatory laws and the impact the spill would have on the people living near the coast of the Gulf of Mexico. I learned that accountants must be able to draw a boundary in a case like this to present financial statements in a good faith effort. I also learned that when a contingent liability cannot be easily determined, a company can still create accounts to offset future losses like the escrow account that BP opened.

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

A contingent liability is an account used for a liability that is not currently owed but can be reasonably estimated and is likely to be owed based on some future event. An example of a time that I company would record a contingent liability is during a lawsuit against the company. If the company and its legal team expect to lose the lawsuit and can reasonably estimate the amount of money to be paid out, that amount would be credited to a contingent liability and debited to a contingent loss. Pending lawsuits and product
warranties are the major types of contingent liabilities. A company cannot record a contingent asset due to conservatism. Gains can only be realized when they are received.

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

From BP’s perspective, the product warranty is an asset. The costs are capitalized along with the telescopic joint if the warranty is sold as part of the joint transaction and not as a separate purchase. The warranty is a liability from the perspective of GE Oil and Gas because they are liable to perform any maintenance or replace any defective joint depending on the terms of the warranty.

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?

In relation to contingent liabilities, management needs to judge the probability of a future payable amount as well as an estimate of said amount. For accrued warranty costs, management should keep track of previous warranty costs incurred and create an estimate of what future costs will be based on historical data. A claim for damages from the Deepwater Horizon oil spill is significantly different from a warranty claim on a piece of equipment. A warranty claim can be reasonably estimated more easily. A company can
estimate the amount of warranty claims that will arise as well as know the costs related to the piece of equipment and the labor that could be required to fulfill the warranty. A legal claim resulting from the oil spill, however, is much more difficult to estimate. The company does not know the amount at which a claim will be settled nor the number of claims that will be brought forward. The scope of the Deepwater Horizon oil spill was so large that it was impossible for BP to estimate a dollar amount in relation to a contingent liability.

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 continued as of early 2011.

Because of the uncertainty regarding the potential lawsuits related to the Deepwater Horizon oil spill, BP was unable to estimate a contingent liability. Instead, BP created an escrow account of $20 billion. The notes to the financial statements state that the $20 billion may be more or less than is necessary to cover the potential costs related to the spill, but the company needed to recognize some type of future liability which they did with the “Provision” account.

Drawing a boundary for the potential losses would be very difficult in this scenario because the number of claims and the monetary amounts related to them are nearly impossible to estimate. If I were the auditor, I would research past oil spills of similar scales to learn how the losses were accounted for as well as if past cases made mistakes. I would also hire legal experts in the environmental field to consult on the expected amount of governmental fines.
The major difficulty comes in the cost of litigation related to businesses and individuals. The Deepwater Horizon had a significant effect on many people’s ability to make a living. The fishing industry is very important along the Gulf of Mexico, and this business was essentially killed by the spill. The oil spill also put people, animals, and the environment in danger because of oil contamination in the water. Tourism is a large part of the economy in the areas around the Gulf of Mexico, and the spill made the beaches unsafe thusly lessening the number of tourists visiting the coast. This meant that hotel operators and restaurant owners were directly affected and had the right to sue for damages.

Is it reasonable for these entities to sue BP due to this spill? I believe the answer is yes. The spill greatly affected the economy along the coast. The fishing industry is the most obvious industry affected. Oil contamination in water leads to oil contamination in fish which renders the fish inedible and worthless to the fishermen and consumers. The hotel and restaurant businesses were also greatly affected because both the effects and the public perception of what the effects were kept people away from the coast. Hotels received many cancellations. Restaurant business was killed with many restaurants forced to close their doors before receiving any funding from BP. Did some businesses and individuals take advantage of the circumstances and receive reparations that were unnecessary? The answer is also yes, but I believe by and large the lawsuits had merit.
Case 9: The Wendy’s Company – Equity Method Investments

John Parker Crane

10 April 2019
Executive Summary

In this case, I explored TimWen, the joint venture of Wendy’s and Tim Hortons. Wendy’s accounted for this joint venture as an equity investment and used the equity method to account for the investment. I learned that the transaction price was greater than the book value of the net assets that Wendy’s was acquiring and that this excess is referred to as Acquisition Accounting Premium (AAP). This AAP is the markup of the net assets to their fair value and is depreciated over time. I had to look through Wendy’s financial statements and determine which accounts were affected by the equity investments into both TimWen and Japan JV. This case showed me how the equity method affects each financial statement. The investments are shown as an asset on the balance sheet, the equity of earnings is shown on the income statement, and the receipt of dividends and recognition of investment income is shown on the statement of cash flows.

Note – All figures are in thousands

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

Companies enter joint venture agreements to receive some type of benefit they would be unable to receive without the help of another company. Joint ventures are often a way to expand a business by using another company’s resources, expertise, or market. In this case, Wendy’s enters a joint venture with Tim Hortons to move into the Canadian market where Tim Hortons is an established brand.
b. Consistent with US 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.

The equity method is a common method to account for the equity investments of a company. The investment should be somewhere between 20 and 50 percent of the investee, and the investor should be able to impose significant influence on the investee. The equity method accounts for the investment with a debit to equity investment and a debit to cash (or whatever other consideration is used). Future journal entries related to the investment affects the equity investment account. Under the fair value method, dividend revenue is recognized when the investee pays dividends, but under the equity method, a percentage of the dividends relative to the investor’s ownership stake (if the investor owns 30 percent, the investor multiplies the total dividends by 30 percent) is credited to the equity investment account thus decreasing the value of the equity investment account because the investor is receiving money back from the initial investment. Likewise, a proportional percentage of the investee’s net income is debited to the equity investment account to show the investor’s portion of the income which increases the equity investment account and recognizes investment revenue by crediting an investment revenue account.
c. When a company purchases shares 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?

The amount a company is worth according to book value is the net assets of the company, or assets less liabilities. Theoretically, an investment of 50 percent of a company would result in a price of 50 percent of the net assets. This, however, is not how transactions usually work. A company’s investment into another company can be split into two accounts under the equity method: equity investment and goodwill. The first step a company must take is finding the book value of their share of the net assets and allocating that portion of the purchase price to the equity investment account. The remaining portion of the purchase price is called the Acquisition Accounting Premium (AAP) which is split into two categories: fair value markup of net assets and goodwill. The fair value of the total net assets must be determined, and the investor’s ownership percentage of that amount equals the portion of AAP related to fair value markup. This portion is allocated to the equity investment account and is annually depreciated by debiting Depreciation Expense and crediting Equity Investment. The goodwill portion of the AAP is tested each year for impairment as well.

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?

According to Note 8, Wendy’s reported the equity investments at $111,533 in 2012 and $119,271 in 2011. This is shown in the balance sheets under the name “Investments.”
In 2012 Wendy’s reported the investment in Japan JV as a negative, and that $1,750 was included in “Other liabilities” on the balance sheet which raised the “Investment” figure to $113,283 on the balance sheet.

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

Wendy’s investment at December 30, 2012 is reported at $89,370. Wendy’s portion of TimWen’s equity (50 percent) is reported at $35,282.5 on December 30, 2012. The difference is made up of Acquisition Accounting Premium that Wendy’s spent in the original investment purchase price. This AAP is due to a difference of the fair value and book value of Tim Hortons’ assets.

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?**

Wendy’s receives a portion of TimWen’s revenues proportional to Wendy’s ownership stake. Wendy’s reported income from investment in TimWen as $13,680 in 2012 and $13,505 in 2011. These numbers appear on the income statement under “Other operating expense, net.”

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

```
Equity Investment $13,680

Investment Income 13,680
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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 in 2012.

The amount of the amortization is $3,129.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation Exp.</td>
<td>$3,129</td>
</tr>
<tr>
<td>Equity Investment</td>
<td>3,129</td>
</tr>
</tbody>
</table>

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.

Wendy’s received dividends of $15,274 in 2012 and $14,942 in 2012 from TimWen.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
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<tbody>
<tr>
<td>Cash</td>
<td>$15,274</td>
</tr>
<tr>
<td>Equity Investment</td>
<td>15,274</td>
</tr>
</tbody>
</table>

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.

The $8,724 negative adjustment on the statement of cash flows under “Equity in earnings in joint ventures, net” results from the $13,680 equity in earnings from TimWen less the amortization of purchase price adjustments of $3,129 less the equity in losses of $1,827 from Japan JV. The negative adjustment is made because the $8,724 is an increase in income for which no cash was received meaning that it should be subtracted from net income on the statement of cash flows under the indirect operating method.
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.

The $15,274 reported on the statement of cash flows is the amount of dividends received from TimWen. The receipt of dividends is a receipt of cash that does not affect net income under the equity method and therefore must be added into net income on the statement of cash flows under the indirect operating method.
Case 10: Johnson & Johnson – Retirement Obligations

Parker Crane

19 April 2019
Executive Summary

In this case, I had to consider retirement obligations for Johnson & Johnson. I discuss how to account for a pension obligation and the relationship between the employer, employee, and fund manager. I learned where to find pension obligation information in the financial statements and what different factors go into the calculation of pension expense, the projected benefit obligation, and plan assets. There are two types of pension plans: defined benefit and defined contribution. Defined benefit plans leave the risk on the employer while defined contribution plans put the risk on the employees. Johnson & Johnson’s financial statements showed how different calculations and estimates figure into the pension plan, the contributions made by the company, and the benefits paid out to employees.

a. There are two general types of retirement plans – defined benefit plans and defined contribution plans.

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

A defined benefit plan is a plan in which the benefit to be received by the employee is a set amount. The company takes on the risk associated with the pension and must contribute to the plan to ensure the benefit will be available upon the employee’s retirement. A defined contribution plan sets the amount to be contributed to the pension plan each period, and the benefit to be paid upon retirement is determined based on the plan assets available. The employee bears the risk in a defined contribution plan.

ii. Explain why retirement plan obligations are liabilities.

A retirement plan obligation is a liability because it is the projected amount of retirement benefits to be paid to employees. The obligation appears on the financial statements of
the pension fund which is its own entity. The obligation is then reported as a liability because the fund will have to pay out the benefits.

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

Assumptions that must be made in order to account for retirement plan obligations include the future years of employment for an employee, the return on the plant assets, the interest on the obligation, and the number of years an employee will receive benefits.

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

Service Cost – the cost associated with the time an employee worked during the current period
Interest Cost – the interest accrual on the projected benefit obligation

Actuarial Gains or Losses – gains or losses associated with actuarial calculations such as the life expectancy of retirees

Benefits Paid – the amount of money paid to retirees which decreases the future obligation because it has been fulfilled

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

Actual Return – the amount of increase or decrease in the fair value of the investments of plan assets

Contributions – the amount invested by the company into the pension plan for a period

Benefits Paid – the amount paid to retirees decreasing the plan assets

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.

The return used for pension expense calculation is an expected return and is based on a projected rate of return. Conversely, the plan assets return is the actual fair value increase or decrease of the plan assets. A projected rate can remain constant in the calculation of pension expense while the market may have fluctuations that cause the actual rate to differ from the expected rate.
e. Johnson & Johnson provides other benefits to retirees including health-care and insurance benefits. What is the primary difference between the company’s other-benefits plans and its retirement plans?

Johnson & Johnson does not fund the other plans in advance and has the right to modify them; whereas, the retirement plans are funded in advance.

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?

$646 million

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

Pension Expense 1,253

PBO 1,253

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?

The balance on December 31,2007 was $12,002 million. This value represents the projected amount of benefits to be paid in the future to current and currently retired employees. This number is reliable.
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.

The interest cost is $656 million. \( \frac{656}{11,660} = 5.63 \) percent. This average interest rate is reasonable because it falls between the 6.5 percent and 5.5 percent discount rates used for the US plans and international plans, respectively.

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

The benefits paid in 2007 were $481 million. These were not paid in cash by Johnson & Johnson. These were paid from the plan assets in the pension fund which decreases both the plan assets and the projected benefit obligation.

h. Consider Johnson & Johnson’s 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?

The value of the plan assets at December 31, 2007 was $10,469 million. This is the fair value of the investments in the pension fund.
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?

In 2007, the expected return on plan assets was $809 million, and the actual return was $743 million. In 2006, the expected return was $701 million, and the actual return was $966 million. These differences are significant and are accounted for as a loss in 2007 and a gain in 2006 in other comprehensive income. I believe the expected return is a better reflection of the economics of a company’s pension expense because it is constant while the market causes the actual return to fluctuate.

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

In 2007, the company contributed $317 million while the employees contributed $62 million. These are both increases from 2006. In 2006, those figures were $259 million and $47 million, respectively.

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

Johnson & Johnson’s retirement plan assets include both equity and debt securities with significantly more equity than debt.

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?

In 2007, the retirement plan was underfunded by $1,533 million and by $2,122 million in 2006. This figure is shown on the balance sheet under “Employee Related Obligations.”
Case 11: On the Balance Sheet-Based Model of Financial Reporting

Parker Crane

28 April 2019
1. This article focuses on the currently implemented balance sheet model of financial reporting and its alternative, the income statement model. The author prefers the income statement model and believes the balance sheet model is flawed. The balance sheet model’s goal is to properly valuate assets and liabilities while are determined by finding the change in net assets. The income statement model stresses the revenues and expenses as opposed to assets and liabilities. The revenue recognition and matching principles are emphasized. Historically, the income statement was more common while the balance sheet approach had its supporters. The FASB wanted to better clarify accounting standards and decided that the balance sheet approach would be the uniform standard. The main factor in this decision was that FASB stated earnings represents a change in value and that a value must be defined before a change can be determined. The FASB has since furthered the balance sheet model by adopting more fair value accounting principles. The balance sheet model has also permeated the international accounting standards.

The author opposes the balance sheet model with a list of four problems. Firstly, he states that a company’s main purpose is to earn revenue and earnings not to valuate assets and liabilities. The operations of a company are far more important than the assets because the assets are temporary and being used to earn revenue. The assets serve a supporting role to earnings and therefore should not be the most important part of financial reporting. Managers often follow an income statement approach when making business decisions, and investors also focus on income statement information. The balance sheet model largely ignores the business’ model and performance. The balance
sheet model makes sense when the company is based on value creation through assets like marketable securities in an investment firm.

The FASB believes that the balance sheet model establishes a solid foundation and an “asset” as the most important accounting concept. However, an asset derives its fair value from the probable future economic benefits associated with the assets. This is ironic because the argument for the balance sheet model is that a value must be determined (asset) before a change in value can be determined (earnings), but the value of the asset is determined in terms of earnings. This means that assets and earnings are connected which makes the balance sheet model’s superiority questionable. The argument can be made that earnings is clearer because it is the same across any business. Assets can be difficult valuate well especially with the growth in presence of intangible assets meaning that the income statement model is better.

Because of the way the balance sheet model determines earnings, projections of future earnings are more volatile. A study found that most changes in the properties of earnings come from changer in accounting instead of the real economy. There is concern that earnings will become meaningless for forward-looking applications which is a threat to the accounting system overall. This also causes problems for unsophisticated investors who cannot understand the problems associated with earnings.

The last problem the author lists is the application of the balance sheet model in practice. It requires estimates of market values and gives managerial discretion as to what some of those figures are. A feedback loop is also created between markets and the real economy. Earnings can go up because the markets are going up which causes the fair value of the firm’s assets to go up as well.
The author presents a better model. The first point is that operating and financing activities should be better distinguished and differentiated so that earnings can be better projected. Assets should also be separated into operating and financing activities. The revenue recognition and matching principles should be emphasized more as well. Overall, economic logic and the business’ core drivers should be considered.

2. Before reading this article, I had never considered the differences between the balance sheet model and the income statement model for accounting. I had simply taken my accounting courses in school without questioning why standards and principles were the way they were. I have always believed net income to be the most important figure presented in financial statements. This article confirmed that notion while also shedding a light on the fact that most of the methods for accounting that I have learned through my principles and intermediate courses are more inclined to state how balance sheet items should be accounted for which then leads to an income statement effect instead of focusing on the income statement.

I agree with the author of the article. Accounting standards exist primarily to benefit the investment community. Investors care much more about a company’s earnings than the balances in asset and liabilities accounts (not to say that those figures are wholly unimportant). If the primary reason for accounting is to benefit the investor, and the investor cares most about a company’s earnings; why does the accounting model put the emphasis on balance sheet accounts as opposed to earnings?

The words “fair value” have been very important throughout my accounting schooling. I always liked that items were reported at fair value because it made the most sense to me. If I paid $14,000 for my car but it is only worth $4,000 now, I should think
of my car as being worth $4,000. However, I had never thought of the purpose of the car. My car’s main purpose is to get me from Point A to Point B safely. I do not plan on selling my car until it can no longer perform its purpose, so its current value is of little importance to me until I intend to sell the car. A business works in the same way. A piece of equipment is going to lose value over time, and that is why depreciation expense exists. However, there is no need to further write down the book value of equipment to the fair value (which would negatively affect income as either a loss or expense) when a company has no intention of selling the equipment.

I also had never thought of the PPE accounts as representing “unexpired costs” as the author states on page four. I found this to be a very interesting and adept description of the PPE accounts, particularly under the income statement model.

I previously had favored the fair value approach for most different accounts, but this article changed my opinion to preferring historical costs (in most cases). I now believe that the income statement model is better than the balance sheet model. However, I also do not expect such a major change to accounting principles and practices to take place.

3. I am unsure as to how I will use this article in my future career in public accounting. I will follow the principles and standards as they are set forth by the FASB and thusly cannot allow my own opinions to affect my work.

If I am in private accounting someday, I may choose not to report assets and liabilities at their fair values because it is not always a true representation of a firm’s value. Fair values can be significantly affected by market changes which can in turn affect a company’s earnings. While this could mean a positive change in earnings for a
company, it hurts the investor in the long run because earnings are more difficult to predict as a portion of earnings is dependent on the market and not the operations of said company.
Case 12: Google Inc. – Earnings Announcements and Information Environment

Parker Crane

3 May 2019
Executive Summary

In this case, I had to learn more about non-GAAP financial performance measures. I previously was not familiar with these measures such as earnings before interest and taxes (EBIT) and earnings before interest, taxes, depreciation, and amortization (EBITDA). Companies provide these measures to investors to give a better understanding of the business. However, these non-GAAP measures can also be seen as a company manipulating earnings to appear in a better light. The reliability of these measures is increasing and have recently seen evidence that show non-GAAP measures are better predictors of future earnings.

The case focuses on a press release from Google Inc. in January of 2014 addressing the earnings from the fourth quarter of 2013. The release includes information about the non-GAAP measures used by Google and what adjustments are made to arrive at the non-GAAP figures. Google removes expenses deemed unindicative of their business operations. I believe there is value both to Google and to investors in the non-GAAP reporting process.

From there, I examined stock market information to see how Google stock was affected after the press release where I found that the stock outperformed the market and was boosted after the release.

Lastly, I read about the different aspects of Google’s core business relating to their earnings. Their earnings underperformed, but stock price still increased, and I had to determine why that apparent contradiction occurred.
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 is a result of an elimination of stock-based compensation expense, elimination of restructuring charges, elimination of taxes related to the previous two eliminations, and to eliminate net loss from discontinued operations. These adjustments are made to remove expenses and charges that Google contends are not indicative of their recurring core business operating results. Google believes that these items provide valuable information to managers and therefore can be useful for investors as well. I agree with Google’s non-GAAP adjustments. I believe that Google is trying to make their earnings appear more attractive to investors, but I also believe that useful financial information can be gleaned from non-GAAP figures. If Google’s managers use this information, then Google’s current and potential investors should be provided with the same information.
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.

The stock price of Google constantly rose after first quarter earnings were reported. Second quarter earnings were disappointing as the price slightly fell. Quarter three saw a large spike in the price, and quarter 4 earnings resulted in both a spike and a drop in a short amount of time followed by a rise back to the previous price.

ii. Compare Google’s 2013 stock price performance with the performance of the broader set of firms trading on the NASDAQ exchange.

Google consistently outperformed the NASDAQ Index. October 2017 saw the NASDAQ and Google take a dip, but Google quickly recovered and saw their stock price spike to outperform the NASDAQ’s recovery.

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?”

The price appears to drop quickly around the time that Google released the press release, but the price recovered to previous levels in less than a month which indicates that the market was neither troubled nor encouraged by the press release.
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?

The fourth quarter revenue was slightly higher than projected, and earnings were lower than projected. The positive stock relation is not consistent with the results. The stock growth makes sense in relation to the revenue growth, but the underperformance in earnings makes the market increase interesting.

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?

I believe the sale of Motorola as well as the growth in ad revenue were encouraging factors to investors. The decrease in revenue per click could be worrying to investors, but the new mobile advertisements may see growth in the number of clicks to offset the decrease in per click revenue.
LIST OF REFERENCES


HONORS CODE AND SIGNATURE

On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on these cases.

[Signature]

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