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A BY CASE ANALYSIS OF ACCOUNTING PRACTICES AND ISSUES

By

John Joseph Walker

A thesis presented in partial fulfillment of the requirements for the Sally McDonnell Barksdale Honors College at the University of Mississippi

Oxford, Mississippi

May 2020

Approved By

Advisor: Dr. Victoria Dickinson

Reader: Dr. Mark Wilder

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ABSTRACT

JOHN WALKER: A By Case Analysis of Accounting Practices and Issues

(Under the direction of Dr. Victoria Dickinson)

The completion of my Thesis came as a result of enrolling in ACCY 420, a course taught by Dr. Victoria Dickinson, designed to provide accounting students with the opportunity to craft the thesis over the course of their junior year in college. This way, students are able to gradually write theses by completing several case studies designed to present students with challenging situations in which real-world accounting issues are explored. With the intensified recruiting process and the internship in the winter of senior year, this class was an excellent method to write the thesis during my junior year of college, before I was extremely busy with my internship and other recruiting obligations.

The cases presented over the course of two semesters ranged from an analysis of potential cities in which I would consider starting a career, to an analysis of Starbuck's financial statements. These cases each provided a unique view at various issues in the accounting world that allowed me as a student to gain a glimpse of issues that I will eventually face as I continue my career in public accounting. The case studies also provided an opportunity to problem-solve and create unique solutions to a problem. As many of the cases were open-ended and could be interpreted in many ways, the space for unique analysis as a student was interesting and beneficial to my learning in this course.

Over the course of my time in this class, I attained several skills that will ultimately be very useful as I continue forward on my career path in public accounting. First, I improved vastly on my ability to work independently in creating analysis for problems in which the answer was unclear or open-ended. In addition, I was able to gain skills in using Excel, a system that is

absolutely vital to work in public accounting, and a tool that I used daily during my internship. Overall, the experience of completing my thesis through the ACCY 420 was an extremely worthwhile endeavor that I found very enriching to my experience at the University of Mississippi. The teamwork involved in the class was great as well, in addition to the connection of the class over the course of the academic year. The accounting thesis program was very beneficial overall to my growth as a student and provided me with skills that I will carry forward into my career.

Case Study #1: Data Analytics- Python

Abstract:

When beginning work on this case, I was entirely unfamiliar with Python and its purpose as a programming language. I had not really had much experience with programs as widely used as Microsoft Excel, much less a programming language. This case forced me to gain a better understanding of technology and to what extent the business world is shifting towards a heavy reliance on data analytics systems, given their ability to increase efficiency exponentially. Researching Python allowed mew to gain a completely new perspective on the use of data analytics in the world of business. I was completely unaware of the potential for a programming language, designed for programmers, to significantly impact the business world and how companies operate from day to day. Data analytics as a whole is a trend that is rapidly increasing in popularity with its relative simplicity and learnability. As I researched Python and its purpose, I discovered its usefulness as a programming language designed to make programming vastly simpler for its users. Python has a broad variety of uses in the business world and makes aggregating data simple and efficient. This program can be used to simplify data, which can help in the accounting and business world to compile large amounts of data quickly and efficiently. Learning Python would be a skill that could separate one in the job application process as a multitalented applicant with skills in programming as well as accounting. Possessing knowledge in programming with Python is a valuable skill in processing data and running data analytics and will inevitably be a significant part of the future of the profession and the ability of accountants to work efficiently.

History and Purpose of Python:

First released in the late 1980s as Amoeba, founder Guido van Rossum pictured a programming language that was readable, simple, but at the same time very effective for users. Rossum was originally working on the development team for ABC, another programming system, but found some of its features frustrating and difficult to use, so he branched off and began work on his own system. In 1994, Python, deriving its name from the British comedy *Monty Python,* was introduced as a new system that emphasized simplicity and readability, aggregating many coding languages to form a simpler programming system. In October 2000, Python 2.0 was released, further streamlining its functionality to create and even more user-friendly system. Consequently, since its use has increased by a factor of ten since 2005, the system has definitely drawn favor from those in the programming and business worlds seeking to use a more user-friendly programming system. With Rossum's departure in July 2018, Python hopes to continue its success into the future as a premiere programming language.

With a vast library of functions, Python is designed to take the best aspects of many programming systems and create a unified system for programming. As a system that can run on many different hardware systems, Python is great for beginning or intermediate programmers seeking a system that is easy to both use and learn, with excellent readability and simple syntax. In the world of accounting, Python can be used to make large collections of data look readable and organized, as well as run data analytics using one of its libraries, called Pandas. For businesses seeking to reduce costs, Python is a simple program that can be taught to employees without having to incur significant training costs to either hire new employees specifically for the purpose of programming or spend large amounts of time training employees to use a complex system. Rather, Python offers a chance for beginners to find simple ways to begin programming

and learn the language quickly. With its high-functioning data aggregating and analytic functions, Python can be very useful in making business decisions and analyzing data.

Python's Use in Auditing:

A large part of auditing involves the verification of financial statements to ensure accuracy in reporting. With Python, an auditor could use the program to synthesize financial data from a company and match those records with financial statements to ensure accuracy. Using Python, an auditor could ensure accuracy and important and stop fraudulent activities much faster than if an auditor was to manually comb through both data and records. Using Python, the process can be expedited to create an exponentially faster method of checking for accuracy and thus ensuring full disclosure. The use of Python in auditing can help to create much more efficient systems for verification and full disclosure.

Another way Python is useful in auditing is comparability. In any given sector of industry, Python can be used to aggregate the financials of companies across a given sector and identify places where discrepancies have occurred in reporting, such as differences in reporting methods in inventory or an improper reporting on financial statements. Python can run programs to analyze data, using Pandas, across an entire sector of industry and ensure that one company is fallowing the same methods used in that specific sector, ensuring accountability for all companies and making sure that reporting is done in an honest fashion. By using Pandas as an analysis tool, the company could become much more efficient in analyzing data to ensure that the company is following the GAAP, as well as accurately reporting information.

A third use of Python in auditing could be to assess potential risks on the horizon for a business. For example, an internal auditor could analyze the financials of the company and use

Python to create a program that would take these financials and analyze trends and behavior, and then predicting future trends that could affect the company down the road. A program created by Python could analyze financials from the company's past and see trends that could cause problems in the future or assess risk by analyzing other companies that have already fallen into the same pitfalls. For example, an internal auditor of an oil or gas company could use Python to analyze the financials of companies in the same sector and even analyze past financial statements and recognize patterns that arise just before a fall in prices. This use of Python could potentially provide a fantastic mode for assessing risk and opportunities, as Python could also predict points where demand would increase for the product. As a result, an oil or gas company could prepare for both a fall in prices or increase production to meet an increase in demand on the horizon.

Python's Use in Tax Planning:

One use for Python in tax planning could be employed in determining the tax rates of clients. If one were employed as a public accountant for a firm that handled the taxes of many individuals and households, Python could be used to write a code to break down the tax scale into a graduated form. By being able to gather the income and data for a variety of clients with a wide range of incomes, Python can be used to create a code to separate the different clients into tax brackets and calculate taxes. In this way, the efficiency of tax planning for accountants is made far easier, as the use of a Python program can be implemented easily and calculate the taxes for a large number of individuals very quickly, eliminating significant work time for accountants. Python can help an accountant navigate the complex tax system and determine the taxes of clients much more efficiently.

In another scenario, an accountant with a non-profit client could use Python and create code that would analyze the structure of an organization, such as assets, liabilities, and cash flows, and proceed to apply this knowledge to the tax code and discover any potential tax write-offs or deductions the organization might be able to receive. Rather than having to manually comb over the complex tax code of the United States, Python could analyze this information much more efficiently. In addition, a program created with Python could catch nuances in the tax code that an accountant working manually might miss. Such a use of Python would create a much more efficient system of analyzing a non-profit organizations financials and create a system in which that company would be receiving the maximum amount of tax benefits to thus allocate additional funds to carry out a purpose that would benefit others.

Another way Python could be effective in tax planning would be for adapting to tax reform for both businesses and accountants. For accountants with a vast number of individuals as clients with a broad range of incomes, adapting to tax reform could prove to be quite a challenge for an accountant not entirely familiar with the implications of new legislation. In 2018, with the passing of a new tax reform bill, accountants and businesses alike must adapt. In such a situation, a tax planner could use Python to write a program to analyze the changes in the tax code and apply them to a broad range of clients. Therefore, free from confusion, Python could analyze the tax code and notice changes with the implementation of a new bill. Subsequently, Python could see where these changes affect various clients and then plug them into an algorithm for the calculation of taxes to determine the new tax rate for a client. An accountant still adapting and learning the changes that the new bill would create could use the program to aid this process and relay information to clients much more quickly. A client would not be blindsided by sudden changes, but would be able to prepare for the changes that would occur. This use of Python helps

both the client and the firm to adapt to changes in the tax code and continue normal operations without interruption.

Why Our Team Should Use Python (Memo):

Memorandum

Date: 5 September 2018

To: Company Leaders

From: John Walker

Re: Reasons our team should use Python

The future use of Python in this company could prove to be very beneficial for the future of the organization and its efficiency. The costs of installing a program like Python company-wide would be a moderate initial expense. However, in the long run, the simplicity and user-friendly program will show its value. The cost of training current employees would be far less than the cost of training employees to use multiple systems or a more complex system, thus taking more time to learn. In addition, the company could avoid hiring a full programming team and simultaneously avoid adding more employees to the payroll. As Python is great for beginning programmers, current employees could be trained seamlessly in its functions and begin to use the system in day-to-day operations in a short amount of time.

In addition to the ease with which the company could integrate Python, another reason the company should acquire Python would be for its efficiency. In the analysis of financials, for example, the process of combing through a vast amount of statements from a variety of clients can become arduous and inefficient. However, Python offers a way to aggregate the data seamlessly and run analyses quickly and efficiently. Using Python for data analysis could create

a much more efficient work environment for our company and eliminate time used to complete one activity and create the ability to accomplish more. In addition, the company would not suffer a loss of staff, but could train current employees to use Python, and allow those employees to train new employees to use Python, creating a system of transferring knowledge, all the while reducing the costs of extensive new hiring. Another reason to use Python would be the ability to increase the scope of operations for the company. With Python, the company could increase its operations in tax planning. With its simplicity and readability, Python would be a great programming system to teach employees and create a more efficient organization, capable of analyzing data at a much faster rate when compared to moderation. Such benefits make Python a great addition to this company to create efficiency for the foreseeable future.

Case Study #2: Rocky Mountain Chocolate Factory, Inc.- Statement of Cash Flows

Abstract:

When working on this case, I had little knowledge of using Microsoft Excel to create financial statements. As a result, this case resulted in a significant learning curve, as I had to learn how to enter data and write formulas in Excel. However I found this case to be quite informative and I learned a great deal on how to write formulas on Excel and apply the formulas to create financial statements. In addition, I found the data entry help me understand creating journal entries much more. It also required a good deal of focus to place all of the transactions in the correct accounts and balance the trial balance. In addition, creating a balance sheet and income statement from scratch based off of a general ledger by writing formulas for Excel was a new experience for me as well and helped me to become better at creating financial statements.

<u>**Case Analysis:**</u>

Part A: Prior to examining the company's balance sheet, read the description of Rock Mountain Chocolate Factory, above. What accounts do you expect do you expect to see on the balance sheet? Which accounts constitute the major assets? Which accounts constitute the major liabilities?

The balance sheet will include all asset accounts, including cash, accounts receivable, inventory, PPE, etc.. Major asset accounts will include cash, accounts receivable, inventory, and property, plant, and equipment. Major liabilities include accounts payable and accrued revenues.

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

Adjustments on Inventory Expense, Depreciation, and Wages paid during the fiscal year may need to be made.

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

General Ledger

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

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

Rocky Mountain Chocolate Factory, Inc.
Income Statement
For Period Ended 2/28/2010

Revenues:	
Sales	22,944,017
Franchise and Royalty Fees	5,492,531
Total Revenues	28,436,548
Costs and Expenses:	
Cost of Sales	14,910,622
Franchise Costs	1,499,477
Sales and Marketing	1,505,431
General and Administrative	2,422,147
Retail Operating	1,756,956
Depreciation and Amortization	698,580
Total Costs and Expenses	22,793,213
Operating Income:	5,643,335
Other Income (Expense)	
Interest Expense	0
Interest Income	27,210
Other, Net	27,210
Income Before Income Taxes	5,670,545
Income Tax Expense	2,090,468
Net Income	3,580,077
Basic Earnings per Common Share	0.60
Diluted Earnings per Common Share	0.58
Weighted Average Common Shares Outstanding	6,012,717
Dilutive Effect of Employee Stock Options	197,521
Weighted Average Common Shares Outstanding, Assuming Dilution	6,210,238

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

Rocky Mountain Chocolate Factory INC.
Balance Sheet
As of 2/28/2010

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 Stockholder's Equity:	
Current Liabilities:	
Accounts Payable	877,832
Accrued Salaries and Wages	646,156
Other Accrued Expenses	946,528
Dividend Payable	602,694
Deferred Income	220,938
Total Current Liabilities	3,294,148
Deferred Income Taxes:	894,429
Commitments and Contingencies:	-
Stockholder's Equity:	
Preferred Stock	-

Series A Junior Participating Preferred Stock	-
Undesignated Series, Authorized 200,000 Shares	-
Common Stock	180,808
Additional Paid-In Capital	7,626,602
Retained Earnings	6,923,927
Total Stockholder's Equity	14,731,337
Total Liabilities and Stockholder's Equity	18,919,914

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

Cash Flows Questions

1. Operating
2. Operating
3. Operating
4. Operating
5. Operating
6. Operating
7. Operating
8. Operating
9. Investing

Adjusting:

10. Financing
12. Operating
13. Investing
14. Operating

Case Study #3: Transparency and Ethics

Abstract:

This case provided a different approach to the first two cases completed in the class, as this case was much more interpretive, as opposed to an analysis of the effectiveness of data analysis tools in the business world or the creation of financial statements on Microsoft Excel. As a result, I found it difficult both to recall and summarize the events of the class, while also explaining my own point-of-view on the topic. The class period provided an open floor debate, where various scenarios, that generally called into question the use of an accounting degree from the University of Mississippi to pursue a career outside of accounting, opened the floor to debate for the class. One student wanted to go into tax law, whereas another wanted to obtain a position at an investment bank with an accounting degree from the Patterson school. In these scenarios, the class was asked to take the side of one student or another. In my own opinion, I am in favor of using the college experience as a time to pursue any degree as a student and apply that degree to obtain any job, whether it be inside or outside of the accounting world. The class period offered a chance to open discussion and see the viewpoints of my peers and how the class as a whole felt about each scenario. I believe in the idea of open discussion as a healthy form of dialogue, where even if opinions differ, two different sides are allowed to provide unique perspectives on issues. This discussion helped me see another point-of-view that I would not have opened my mind up to had I not listened to the thoughts of my classmates. In the different scenarios, I tended to favor those students who argued in favor of pursuing a career outside of accounting, while still completing an accounting internship and obtaining an undergraduate degree from the school of accounting, as I believe in choosing the career path that is best for the individual, not because of the pressure to follow the conventions of the accounting program. However, at the end of the discussion, Dr. D explained the reasoning behind the in-class debate and why the discussion was

important. In summation, the school of accountancy maintains its place as a top school because of the high-caliber students that it produces. However, another aspect of the prestige that the school has achieved is from the willingness of students from the University of Mississippi to remain in those firms and perform highly as an employee. In this way, I learned that part of the school of accountancy's ability to maintain its place as a top program is the ability of the school to convince the firms that students will remain at that firm for a solid amount of time, so as to justify the allocation of resources to recruiting and training new employees. I did not know before how important it is for the school to convince recruiters that students will stay at a firm to remain a top school and keep the firms interested in recruiting at the University of Mississippi. Overall, this forum of debate offered a new perspective in my view on different cases of students in the school of accountancy, as well as how the Patterson school is able to remain at a top standing in the nation.

Scenario #1:

In the first scenario presented to the class, two students engaging in a conversation expressed varying viewpoints on the use of an Accounting degree from the University of Mississippi. Student One took explained that because his or her brother worked as a tax lawyer in a law firm and made a high salary, that he or she would use the accounting degree and an internship through the accounting program to get into law school and augment a law-school application. Student Two took the approach of the conventional approach to the Patterson School of Accountancy, saying that he or she would rather use the internship through the accounting program to gain an job offer in a desired city and office, and then pursue a career in that firm, claiming that the schooling would be far less and the cost-benefit of coming out of college and

making money immediately would be higher than attending a costly law school program for three more years and delay the immediate benefits of earning a salary.

Upon hearing these two scenarios laid out, I opted to vote in favor of the first student who wanted to attend law school and become a tax lawyer. In my opinion, if someone has no desire to be an accountant and would rather attend law school, then that is his or her prerogative. Law school is expensive, but a student coming out of law school as with the title of J.D. behind their name can either enter into a high-paying job at a law firm or become more competitive as an applicant for a job in tax law at an accounting firm. Even though the pay difference is not significant, the student that opts to attend law school can leave college with a degree in law and accounting and immediately apply enter into law or an accounting firm. However, student one does have an absolutely legitimate path to a career, with the conventional method of using the accounting school to acquire an internship and then accept a job offer from that firm. While both views of the use of the degree of accounting at the Patterson School are valid, I tended to favor the idea of pursuing the best possible undergraduate degree to help with future career pursuits, even if one does not intend on using that degree to acquire a job in that field.

Scenario #2:

In the second scenario, Student one wanted to use an accounting degree to enter into investment banking, citing the lackluster business program and the prestige of the accounting program. The student claimed that only by obtaining an accounting degree could he or she hope to be competitive in applying for an investment-banking job. Student two, on the other hand, wanted to enter into consulting with an accounting firm with the idea of traveling the world and doing career work similar to that of the case competitions.

In my experience, I found this scenario a difficult option in choosing a side to support. In the end, I sided with student one, who wanted to use an accounting internship to gain a foothold in the investment-banking world and then apply for a job at an investment bank. While the student wanting to enter into consulting with an accounting degree also had a valid viewpoint as well, as both did not want to be accountants, but one wanted to enter into the banking world and not the accounting world. I tend to favor pursuing any degree in college as a means to an end for a career, as anyone can choose a profession and is not bound to a career in accounting simply because he or she obtained an undergraduate accounting degree. Even if one completes an internship with an accounting firm, doing so has the ability to help that person become a more competitive applicant for an investment-banking job, and that student should not be faulted for fully utilizing the resources that are available at one's university. For this reason, I favored the side of the student that wanted to use the school of accountancy to obtain an investment-banking job, as I believe that one should be able to pursue any career option and not feel pressured to have to work in the field of his or her degree, but follow a desired career path and obtain the degree that would make that applicant a more appealing candidate. This debate provided two scenarios in which the students in question were both in favor of pursuing career paths aside from audit or tax accounting, but still using the accounting program as a tool to obtain those goals. In any case, student one's position of using the accounting program to obtain a position at an investment bank by way of the Patterson school is a completely legitimate path considering the resources available to that student at the University of Mississippi.

Scenario #3:

This scenario presented a student that had emailed Dr. Dickinson, stating a desire to transfer to another office in his or her hometown in Dallas after completing an internship in

Washington, D.C., stating that the office simply was not a good fit and that Dallas would be a much better option. As this was the only information given at the time of choosing sides in the in-class debate, I favored the side of the student in this case. Someone that takes an internship offer in one city, but later discovers that living in that city was not as appealing as it once appeared should not have to stay there for an entire career. Requesting to transfer to another office is a completely reasonable proposal. However, the student did suggest any other firm would be a viable option as well, which disregards the time and resources the D.C. office has spent on that recruit. Nevertheless, I originally sided with the student in this matter.

However, the class then heard the response given by Dr. D to the student regarding a transfer. In the response, Dr. D outlined the potential difficulty in moving to a popular office such as Dallas, who had probably already given job offers its intern class and had a limited number of spots already. As a result, moving to the Dallas office could prove difficult immediately. Dr. D encouraged the student to possibly try and stay at the firm for a short amount of time longer and see if anything changes, and wait on the opening to transfer to Dallas. While I originally sided with the student, Dr. D's response was reasonable and accurate. While wanting to transfer to another firm is reasonable and happens quite often, this student's request to move to a location that is very sought after could lead to difficulties in finding a spot in the long term. In addition, with internships being only eight weeks, the student may have been acting hastily in immediately deciding to want to move to his or her hometown without giving even more than half a year to decide if the office was the right fit. Furthermore, the student made contact with Dr. D near the end of graduate schooling, when the student was to report back to D.C. in nearly three months, which is a very narrow window to gain a better chance to have a transfer request completed. Overall, the student found himself or herself in a difficult position with the transfer

attempt, but Dr. D's response clearly outlined the difficulties in making such a move in such a short amount of time to a highly sought after job location.

Case Study #4: Generic Bank-Accounting for Debt Securities Sales and Impairments

Abstract:

This case dealt with the sale of securities by a bank and the determination of whether or not an impairment loss had occurred in various scenarios. Before working on this case, I had no previous knowledge of securities and how they were treated with regards to reporting an impairment loss. This case forced me to delve into the FASB and look into how auditors look at securities and their sale. In addition, this case asked me to see these transactions from the perspective of a bank regulator as well. Unlike any of the cases prior to this one, I was forced to learn independently for this case and apply what I had read from the FASB codification to the facts of the case. As a result, this approach to the case led to some ambiguity on whether or not I had made correct assessments in whether an impairment loss had occurred or not. The case also challenged me to analyze financial statements in a way that I had not done so before. Rather than creating financial statements with information provided, the case facts provided all of the information needed and allowed me to assume the role of an external auditor to make assertions on the effect of the sale of securities on financial reporting. In this way, I had not been challenged in this regard with any accounting class. This perspective afforded me the chance to use a different set of skills, involving more analysis rather than knowing how to create financial statements. While the case was very difficult and challenging to find concrete answers, the case challenged me to learn more about how to analyze financial statements and make determinations from the information they provide.

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 did incur an impairment loss on the seven securities sold in the 20x3. The FASB defines an impairment loss as a loss that is a product of selling assets that are no longer valuable to hold. The company sold seven securities at the end of the year 20x2, and this sale resulted in a loss of $54.209 million. Although the sale resulted in an increase in cash of $331.835 million, the loss shows that an impairment loss was incurred. An analysis of the value of the securities shows that the securities ending in 003, 025, 030, and 076 held significantly higher amortized costs over fair value, making them a financial burden for the bank. While the three other securities held higher fair values over the amortized costs, the differences did not mitigate the losses that occurred in the sale of the four other securities. The securities, as a whole, have a much higher amortized cost than their combined value. Therefore, their sale results in a loss overall. Even though a sale of assets may result in immediate liquidity and an increase in cash, by definition according to the FASB, Generic Bank has no ability to assert that these seven securities could be held until the value of the securities would recover. With such significant amortized costs, the sale of these seven securities shows that they could not reasonably be sold without incurring an impairment loss.

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?

With the securities that Generic Bank did not sell, an impairment loss did not occur. Because no assets were sold, even if the amortized costs of the unsold securities are higher than the total fair value, with no clear way to determine if an impairment loss has occurred. In

addition, since Generic Bank operates under the assumption that changes in interest rates result in more losses than deterioration, the increases in interest income from 20x0 to 20x2 denote that the gap between amortized costs in fair value can possibly be compensated by the increases in interest income. In addition, because there is no rule application to determine if impairment has incurred on a portfolio of securities, neither Generic Bank nor an external auditor could reasonably determine that impairment has occurred. With the sale of the seven securities, a loss was realized. However, with assets being held, there is no way to determine if impairment has occurred, even if the amount of depletion is more than the air value of the portfolio. As a result, because Generic Bank is still holding the securities, impairment has not occurred as the value of those assets holds the potential to recover.

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?

When looking at this issue from the perspective of Heather Herring, an external auditor, her job is to determine whether the sale of securities does result in an impairment loss or not. From this perspective, considering the depletion level of the securities with regards to fair value and amortized cost, an external auditor would likely report that an impairment loss had occurred. However, with regards to the second question, the answer becomes more ambiguous. Whereas there are no rules dictating if impairment has occurred, the holding of the securities may show the ability for the assets to recover their value. One external auditor may report that impairment has occurred, where one may see potential for the assets to recover value and avoid a loss. From the perspective of a bank regulator, the answer to the first question likely would not change, as a bank regulator is held to a standard of regulations from various entities, such as the SEC, and

regulations under the FASB. Consequently, not reporting an impairment loss when the bank sold securities that the bank likely could not prove would recover their value would mean that the bank regulator would report an impairment loss. Regulators have an obligation to maintain credibility and report information accurately. For the second question, a bank regulator likely would not report an impairment loss, as the bank has no motivation to report a loss on assets that are still being held. Because there are no explicit rules for realizing an impairment loss in the FASB, a regulator would have no obligation to report a loss, as the regulator may still believe the assets will recover their value. An external auditor or a bank regulator would likely consider the differences between the amortized costs and the fair value when determining if an impairment loss has occurred. In addition, both would likely also look at the net unrealized losses on securities available for sale, which are significant and would therefore indicate an impairment loss on the seven securities sold. For the securities being held, there is no true method to determine a loss or gain, resulting in an inability to make an exact determination if an impairment loss has occurred.

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?

If all the securities were in a collective net gain position, the seven securities would need to be analyzed to determine if the seven securities that were sold were in a net gain position. If so, then an impairment loss would likely not be reported. If the seven securities were in a position of net loss, then an impairment loss likely would be reported. However, when analyzing the remaining securities held by the bank, if they were in a position of net gain, then an impairment loss would not be reported, as the securities are still maintain their value and do not

have to recover any depletion. If all of the securities were sold in a position of net gain, then an impairment loss would also not be reported as the securities were in a position of gain and the bank would not lose any money through their sale.

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?

Again, because the bank continues to hold the securities in hopes that their value will recover, an impairment loss has not occurred. As Generic bank has not placed the other securities for sale at this point, it has no reason to write the securities down to fair value and report an impairment. In addition, the holding of the securities from year 20x2 to 20x3 shows that the bank is showing the ability for the securities to recover value over that of the rate of deterioration. Because the bank is responsible for reporting whether or not impairment has occurred under ASC 326-30, the bank would likely not report impairment due to the reduction on income that would occur. As a result, even if the securities held a fair value less than the rate of amortization, the bank would still not report a loss. Furthermore, because of the lack of guidelines dictating whether or not securities still being held are impaired, then Generic Bank has no reason to establish a credit loss account for the securities, as

Case Study #5- Overview of Potential Career Cities

Boston:

Figure 5-1: Image of Boston

Boston, Massachusetts is located in the New England region of the United States, with a population to 685,094 people and a greater metropolitan area population of 4.7 million. Boston is a large, vibrant city with many opportunities. Considering my desire to live in a moderately large city, Boston is an ideal spot, as it has a large population, but is not overwhelmingly large. The city has a continental climate, with cold and snowy winters, and warm summers. The seasonal differences in Boston are very noticeable, and as someone born in the South, I would need to adjust to a colder climate. As a coastal city, Boston experiences increased moisture in the air due to its proximity to the Atlantic Ocean, and the Mystic and Charles Rivers surround the city on either side. Boston's terrain is hilly, although swampland used to dominate the region. However, several hills were demolished to fill in the land.

Figure 5-2: Boston, MA Map

The rate at which a single individual living in Boston would be taxed is as follows:

Figure 5-3: Boston, MA Tax Rates

Tax Type	Marginal Tax Rate	Effective Tax Rate	2017 Taxes	2018 Trump Taxes*
Federal	25.00%	11.28%	$5,639	$4,370
FICA	7.65%	7.65%	$3,825	$3,825
State	5.10%	4.65%	$2,326	$2,321
Local	0.00%	0.00%	$0	$0
Total Income Taxes			$11,789	$10,516
Income After Taxes			$38,211	$39,484

The state of Massachusetts utilizes a flat income tax rate with no additional local taxes. However, the state does charge a 6.25 percent rate of sales tax at a flat rate as well, which would

be a significant expense. Making $50,000 a year, I would be taxed heavily as a single person and would lose over 20 percent of my annual income to taxes. The rate of property tax that I would pay in Suffolk County would be 0.862 percent assessed value of the home, adding to my total level of taxation as a prospective future resident.

The city of Boston's air transportation hub is Logan International Airport, which is ranked as the sixteenth largest airport in the United States, serving as a destination for multiple major commercial airlines. A large airport in close proximity to the city center makes Boston very accessible by air. In addition, Boston's main Amtrak hub is South Station, located in the downtown area, which provides rail access to the rest of the United States. Boston also has three interstates, I-90, I-95, and I-93, all of which are major corridors into the New England region by automobile. Overall, Boston is very accessible and would be very easy to access from other parts of the country.

Major industries in Boston include education, with universities such as Harvard, MIT, and Northeastern. These renowned institutions makes Boston a hub for education and a city filled with young people, making it a great place to be a young person coming out of college. Boston is also known for Biotechnology, tourism, and financial services. As a future accountant, the prevalence of Boston as a financial market makes it a great place to be an accountant, all the while being a hub for tourism from around the country and even the world. Boston also ranks in the top ten cities in the nation for best healthcare. With excellent universities and an excellent education system in the area, the city has great access to healthcare.

As far as crime, Boston is a relatively safe city, but does have a few areas that one would definitely need to avoid. Roxbury, Roxbury Crossing, and Dorchester are all areas to avoid, with high rates of violent crime and property crime. In Boston as a whole, common crimes

include assault, drug possession, OUI, vehicular homicide, and firearms and weapons charges. However, Boston is a safe city and is commonly listed as a great large city for safety.

For renters, residents in Boston pay large amounts of rent. Commonly, one-bedroom apartments in the downtown area of Boston range anywhere from $800-$2,500 per month. With many places being studio apartments with only one bedroom, a roommate would not be necessary. However, living in the city center near the financial district entails large rent, which means that roommates could result in a better system of sharing the financial burden. A two-bedroom, two bathroom apartment at 170 Tremont Street, in the heart of downtown, is listed at $1,300 per month. The property 1,430 square feet and is furnished, with a washer and dryer and appliances. With a washer and dryer, I could do my laundry in the apartment, eliminating the need to use a laundry mat. The apartment also has access to 95 parking spaces and has immediate access to downtown Boston.

Figure 5-4: Boston, MA Apartment

Commuting from an apartment in downtown Boston is an easy process, due to the small area of the city, at 86.2 square miles, making walking a common way to get around the city. A commute to a place of employment from this property, located near Boston Common, would not be a far walk. In addition, Boston has a great public transportation system, with a subway system known as the T. The public transportation in Boston makes the use of a car largely unnecessary, cutting down on costs for maintenance of a car and insurance expenses. From this property on Tremont Street, a walk to the downtown financial center of the city is only an eleven minute walk, making walking a great way to commute in Boston due to its compact city center. Within walking distance are several places to do grocery shopping, including a Trader Joe's and a Whole Foods, with two international marketplaces in immediate walking distance. Boston's compact nature makes it an easy by to get around on foot and easily access essential living needs as well as a place of employment.

Boston has many churches in the area that I would be able to attend, such as First Baptist Church of Boston, located in downtown. In addition, various charities are in the area, including Habitat for Humanity. In addition, I could become involved in Boston Cares, a greater metropolitan area agency that organizes various community activities in over 180 schools in the area. Becoming involved in such organizations would be a great way to become involved in the community and make connections in the city. In the realm of entertainment options, Boston is home to some of the best sports teams in the nation, such as the Boston Red Sox, who recently won the World Series in 2018, and the Boston Celtics, an historic NBA team with 17 championships. In addition, the New England Patriots and Boston Bruins are excellent sports teams in their respective leagues. As a big Red Sox and Celtics fans, I could attend games on a regular basis throughout the year. Boston also offers great recreation opportunities, such as

Charles River kayaking and the Boston Harbor Islands Recreational Area. These spots provide great outdoor experiences just minutes from downtown Boston. In addition, I could see various Broadway shows that play in venues such as the Boston Opera House, which include Hamilton and School of Rock. Traveling home from Boston would most likely require a plane flight, as the drive is nearly twenty-four hours. A plane ticket to travel to Jackson, MS costs anywhere from $280-$450, based on the airline. Overall, a trip home is not terribly expensive, but is expensive enough to where I likely could not travel home every month. As a result, three to four trips home per year would be the likely option based on the travel expenses. I would still be able to visit home, just not as frequently as I am currently able as a student at Ole Miss, as the distance from Boston to Jackson is over 1,400 miles.

Figure 5-5: Boston, MA Budget

Year 2 Operating Budget

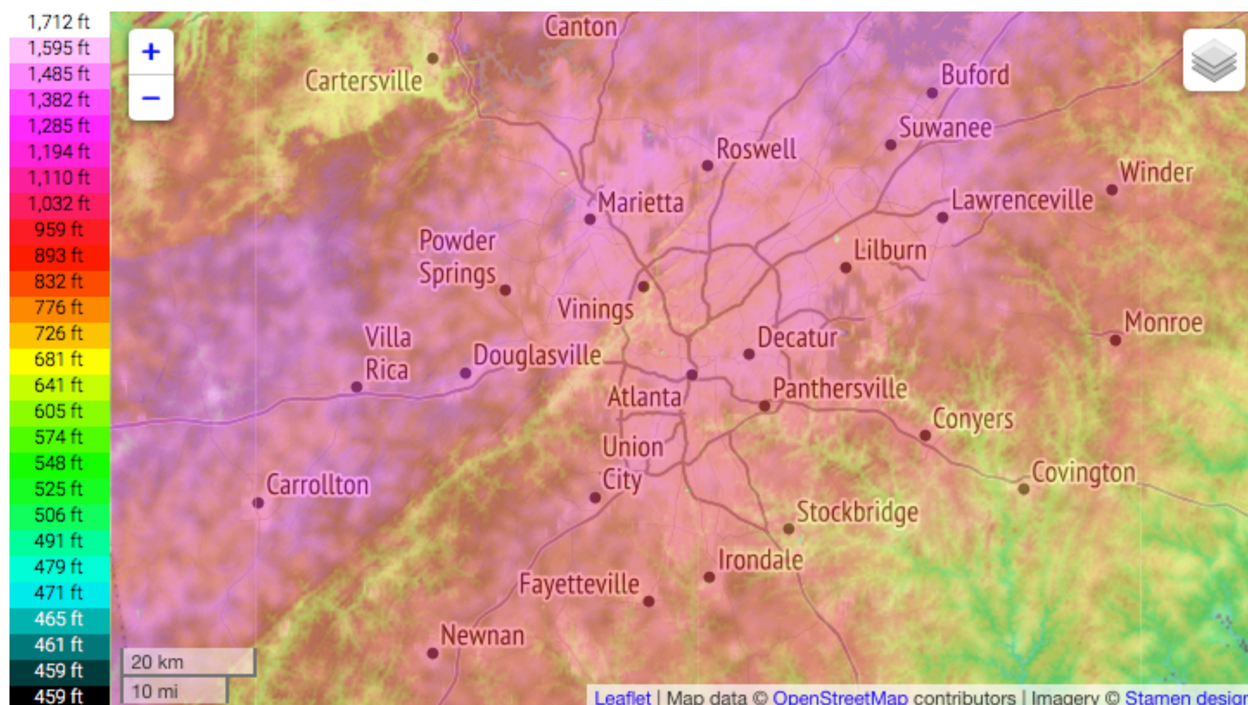
	January	February	March	April	May	June	July	August	September	October	November	December
Monthly Rent	900	900	900	900	900	900	900	900	900	900	900	900
Groceries	400	400	400	400	400	400	400	300	300	400	400	400
Public Transportation	75	75	75	75	75	75	75	75	75	75	75	75
Healthcare	150	150	50	50	50	50	50	50	50	50	50	50
Savings (10%)	600	600	600	600	600	600	600	600	600	600	600	600
Taxes	1,170	1170	1170	1170	1170	1170	1170	1170	1170	1170	1170	1170
Utilities	160	160	160	160	160	160	160	160	160	160	160	160
Car Expenses	50	50	50	50	50	50	50	50	50	50	50	50
Miscellaneous	1000	1000	1000	1000	1500	1000	1000	1000	1000	1000	1500	1500
Sales Tax	62.5	62.5	62.5	62.5	93.75	62.5	62.5	62.5	62.5	62.5	93.75	93.75
Total	4567.5	4567.5	4467.5	4467.5	4998.75	4467.5	4467.5	4367.5	4367.5	4467.5	4998.75	4998.75
Bonuses (3%)	3000											
Leftover	4796.25											
Total at Year-End	7796.25											

Atlanta:

Figure 5-6: Image of Atlanta

Located in Northern Georgia and has a population of 486,290 people, and a metropolitan area population of 5.8 million people. Atlanta has a humid subtropical climate, which entails very hot, humid summers and mild winters, with comfortable springs and fall seasons. The seasons do not fluctuate to extremes often, but as Atlanta is a southern city, it experiences very hot summers. The city of Atlanta is located at 1,050 feet above sea level, the highest of any city east of Denver in the United States. As someone who has grown up in the South, I am already accustomed to long, hot summers and mild winters, so the seasonal transition would not be significant. The climate of Atlanta would be nearly the same as I experienced growing up in Jackson, MS.

Figure 5-7: Atlanta, GA Elevation Map



As far as taxation, a single individual in Atlanta would pay around 11.28% in federal income taxes, as well as 5.3 percent in state income tax. The combined sales tax rate in Atlanta is 8.9 percent, which is a considerable amount. The taxation breakdown in Atlanta is as follows:

Figure 5-8: Atlanta, GA Tax Rates

Tax Type	Marginal Tax Rate	Effective Tax Rate	2017 Taxes	2018 Trump Taxes*
Federal	25.00%	11.28%	$5,639	$4,370
FICA	7.65%	7.65%	$3,825	$3,825
State	6.00%	5.30%	$2,648	$2,641
Local	0.00%	0.00%	$0	$0
Total Income Taxes			$12,112	$10,835
Income After Taxes			$37,888	$39,165

I would pay a little more than 20 percent of my annual earnings in taxes, making the level of taxation as an Atlanta resident significant.

Atlanta is a major transportation hub in the South, with the world's largest airport in Hartsfield-Jackson International Airport. In addition, several major interstates run through Atlanta, including I-85, I-20, and I-75. These major thoroughfares and the massive airport that Atlanta holds makes it very accessible from any part of the world and a major hub of transportation in the United States. No industry truly dominates the local economy in Atlanta, but several major companies call the city their headquarters, including Coca-Cola, UPS, Delta Airlines, BellSouth, Georgia-Pacific, and Home Depot. As a result, the city has many opportunities in business and is a great city for accounting. In healthcare, Atlanta is not the best city; access to healthcare can be limited in the state of Georgia. The state has received criticism for its healthcare system, but hospitals are accessible near the downtown area of the city.

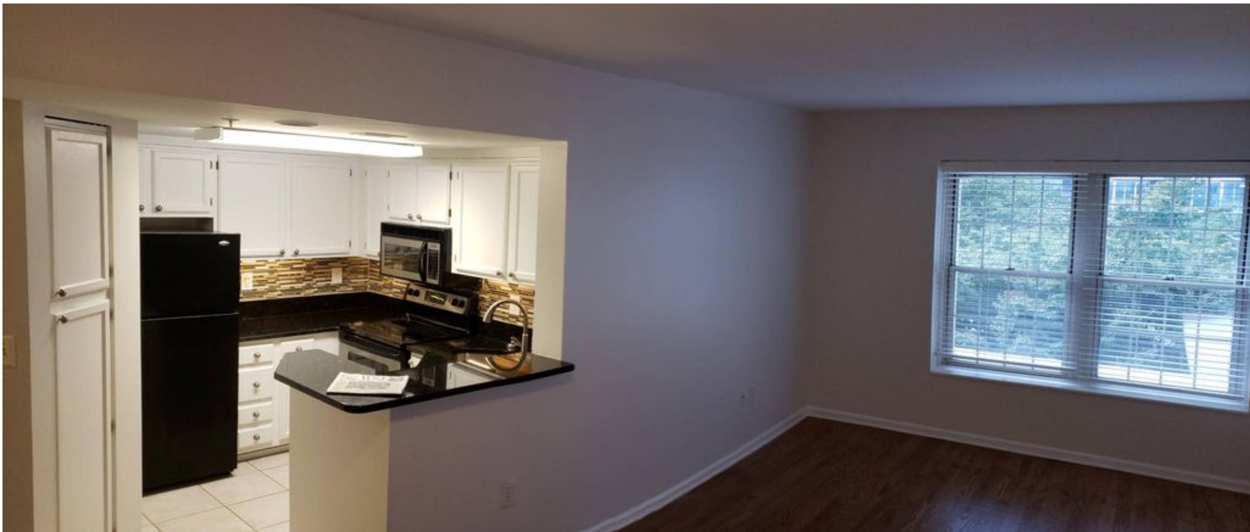
Atlanta is a city known for high crimes rates. However, as the city is divided into six distinct zones, certain areas of the city are notorious for high crime, while others are relatively safe. U-Rescue Villa, Old Fourth Ward, and Kirkwood are all neighborhoods that are to be avoided. In addition, areas south of the I-20 and I-85 interchange are known to be more dangerous and high with gang activity. In general the northern and eastern area of the city, including the Buckhead and Midtown areas are very safe. Nearly eighty percent of property and violent crime is also related to gang activity, which is a signal to avoid neighborhoods prominent with gang activity.

To rent in Atlanta, a 2-bedroom apartment in Atlanta costs around $1900 per month. Having a roommate would be ideal in the downtown area of the city to help with utilities and rent prices. A unit in midtown Atlanta at 199 14th St. Northeast is $1900 per month, with parking and laundry coming as a part of the unit. The location of the complex is right in the center of

Midtown, just north of the Downtown area and a short commute to the financial center of the city.

Figure 5-9: Atlanta, GA apartment

Figure 5-10: Atlanta, GA Apartment



In Atlanta, while a public transportation train system known as MARTA operates in the city, the automobile is far and away the dominant mode of transportation. As a result, I would spend money on gas and other car expenses, such as oil changes and repairs. I would most likely need to commute to work and other places, as Atlanta is very spread out and the metropolitan area covers a massive area in northern Georgia. The drive to downtown from Midtown is nine minutes, meaning a commute to work would be relatively short. However, making trips to areas in the outer areas of the city could result in long drives, considering the notorious traffic in Atlanta. Several grocery stores, including Whole Foods, Trader Joe's, and Kroger are all within a short drive from Midtown and would be easily accessible places to buy groceries.

As a city in the "Bible Belt" region of the country, Atlanta has several churches that I could attend as a resident, all within a short drive in the area. Community organizations that I could join include Trees Atlanta, an organization dedicated to maintaining the urban forestation of the city and keeping Atlanta a city with a multitude of green areas to enjoy. Furthermore, several animal shelters operate in the area, and as a passionate dog person, I could volunteer at a

local shelter. Atlanta is a vibrant city, with many opportunities for engagement and service in the community, and finding such activities would be a priority.

Atlanta is also a city full of activities and entertainment. Sports teams such as the Atlanta Falcons in the NFL provide a great team to watch, especially in the new Mercedes-Benz Stadium, a state-of-the-art facility. In addition, the Atlanta Braves, the local MLB team, also boast a new stadium and are a great tem to watch play. The Atlanta Hawks and Atlanta FC also play in the city. The Georgia Aquarium is a well-known attraction and is known as one of the best aquariums in the world. Coca-Cola World is also a popular attraction to see in the downtown area of the city. The Beltline, a park converted from an abandoned railway is a great urban development project that cuts right through the heart of the city and is a great way to experience quiet and exercise right in the city center. Atlanta is full of activities and entertainment and would be an easy place to keep myself busy as a resident, with endless opportunities for entertainment. Traveling home from Atlanta to Jackson is about a six-hour drive, making such a journey a very manageable trip. Therefore, I could make trips home fairly easily and avoid paying the price for a plane ticket. Atlanta is an accessible city from Jackson by interstate, as the two cities are linked directly by I-20.

Figure 5-11: Atlanta, GA Budget

Year 2 Operating Budget

	January	February	March	April	May	June	July	August	September	October	November	December
Monthly Rent	950	950	950	950	950	950	950	950	950	950	950	950
Groceries	400	400	400	400	400	400	400	300	300	400	400	400
Healthcare	150	150	50	50	50	50	50	50	50	50	50	50
Savings (10%)	600	600	600	600	600	600	600	600	600	600	600	600
Taxes	1,170	1170	1170	1170	1170	1170	1170	1170	1170	1170	1170	1170
Utilities	160	160	160	160	160	160	160	160	160	160	160	160
Car Expenses	300	300	300	300	300	300	300	300	300	300	300	50
Miscellaneous	1000	1000	1000	1000	1500	1000	1000	1000	1000	1000	1500	1500
Sales Tax (8.9%)	89	89	89	89	133.5	89	89	89	89	89	133.5	133.5
Total	4819	4819	4719	4719	5263.5	4719	4719	4619	4619	4719	5263.5	5013.5
Bonuses (3%)	3000											
Leftover	1988.5											
Total at Year-End	4988.5											

Abstract:

In completing this case, I did not anticipate the level of thinking that goes into completely moving to another city, especially a large city with many options as far as living and entertainment. The factors for evaluation a city provided an interesting comparison between the two cities I have chosen as my two top cities. Boston is a northern, more compact city predicated on traveling around by public transportation and walking, while Atlanta is a suburban sprawl of a city with massive highways located in the Deep South. Culturally, the two provide two different approaches as well, with Atlanta being placed in the more laid back south, while Boston sits in the heart of the northeast, where a more fast-paced lifestyle is normal. Overall, the cost of living in both cities is fairly expensive, where living near the center of each city is a significant financial burden, and living with a roommate is likely necessary. Boston is far less accessible to my home, Jackson, MS, as a flight would be the most likely option to travel home. On the other hand, Atlanta is only a six-hour drive from Jackson, making the ride home very manageable. The two cities each offer great entertainment and endless activities, such as outdoor recreation, sports, and culture. Boston is the more educated city and also has far better healthcare, and the city is also a center of history. I think that when evaluating the two, I want to live in Boston more, as I find the city to be an excellent place for young people, with so many universities in the area, as well as an up and coming tech hub, coupled with an established financial sector. In addition, the city feels a little smaller with its compact area and is very easy to navigate on foot. As I am also not bothered by very cold winters, I would not mind the seasonal transition in moving from Mississippi. While both cities offer great opportunities and a distinct culture that comes with each, I personally would rather live in Boston for its vibrant atmosphere and tradition as the cultural center of New England.

Case Study #6: WorldCom, Inc.- Capitalized Costs and Earnings Quality

Abstract:

When beginning work on this case, I found the fact that WorldCom was the subject of analysis very interesting. As someone from Jackson, MS, I am familiar with the company and know people that worked for WorldCom up until its implosion due to improper accounting. However, I was unaware of the scale to which WorldCom misrepresented its financial standing and misled investors to believe that it was bringing in gains, when in reality the company was experiencing losses. As WorldCom capitalized on over three billion dollars in line costs, the consequences of the company's demise sent ripples throughout the accounting world, as over 500,000 people lost their jobs. Such an incident shows the consequences of misrepresentation on financial statements, especially in the amounts to which WorldCom misrepresented its financial position. The company shut down immediately and the top executives of the company faced jail time. With the pressure of appeasing shareholders with millions of dollars at stake, the controllers of WorldCom thought that capitalizing losses at he time would increase net income at the time but eventually even out over time. However, the company still falsely reported billions of dollars in expenses, showing that the consequences of negligent accounting has serious consequences, and can lead to the downfall of companies and loss of jobs.

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

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

SCON 6 defines an asset as a holding that a company expects to produce future economic benefits. Examples of assets include cash, buildings, and equipment. Expenses result from the use of assets or the incurrence of liabilities. To be classified as an asset, the item must have the capacity to contribute to future cash

flows, the ability for the entity to controls others' access to it, and the transaction for the entity to possess the asset must have occurred.

Expenses are activities that are essential to continuing a company's operations, the using up of assets, the incurring of liabilities from delivering or producing goods, or rendering services. The outflow of cash must have occurred to be considered an expense.

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

Costs that help in achieving future economic benefits should be capitalized, but costs that are only needed to maintain a current level of service should be expensed.

What becomes of "costs" after their initial capitalization? Describe, in general terms, how the balance sheet and the income statement are affected by a decision to capitalize a given cost.

When assets are capitalized, the total assets will increase on the balance sheet, because capitalized costs become fixed assets. In the case of the Income statement, capitalization of assets leads to an increase in Net Income sooner, whereas expensing assets will result in higher Net Income over the long-term.

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 its line costs for the year ended December 31, 2001 as $14.739 billion. Line Costs, as defined in the SEC case report for the WorldCom scandal, are costs incurred by WorldCom paid to local telephone networks to complete calls.

The proper journal entry would be as follows:

Dr	Line Cost Expense	14,739,000,000	
CR	Cash		14,739,000,000

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 article in the *Wall Street Journal,* the costs that were improperly capitalized were line costs, where WorldCom paid telephone providers to access local networks to complete calls. With these costs came access charges and transport charges, as cited by the SEC. In reference to part a, these costs do not fit the definition of assets, as line costs do not lead to the achievement of economic benefits, bur rather maintain a current, sustainable level of operation for the company. Therefore, WorldCom should have expensed these line costs in accordance with accounting standards.

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?

The journal entry for the improper capitalization of line costs would be as follows:

Dr	Property, Plant, and Equipment	3,055,000,000	
Cr	Line Cost Expense		3,055,000,000

The improperly capitalized line costs are added to the Property, Plant, and Equipment section of the balance sheet, whereas the capitalized costs appear in the investing section because of the addition to the value of Property, Plant, and Equipment from this capitalization.

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.

The calculation of depreciation expense is as follows, given a useful life of 22 years:

(771,000,000/22) x (4/4)= 35,045,455

(610,000,000/22) x (3/4)= 20,795,455

(743,000,000/22) x (2/4)= 16,886,364

(931,000,000/22) x (1/4)= 10,579,545

Total Depreciation Expense: $83,306,819

The journal entry to record depreciation is as follows:

Dr	Depreciation Expense	83,306,819	
Cr	Accumulated Depreciation- Equipment		83,306,819

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?

Assumptions that I am making in these calculations would be that the stated operating income and other income numbers are correct. The difference in the net income is material because the losses were extremely high and resulted in a significant change in WorldCom's economic position.

The corrected calculation of WorldCom's net income for 2001 is as follows:

Operating Income	3,514,000,000
Other Income (Expense):	
Interest Expense	<1,533,000,000>
Miscellaneous	412,000,000
Income before taxes	2,393,000,000
Add: Corrected Depreciation	83,306,819
Deduct: Improperly Capitalized Line Costs	<3,055,000,000>
Losses Before Taxes	<578,693,180>
Minority Interest	35,000,000
Income Tax Carried into Nest Period (35%)	202,542,613
Net Losses	<341,150,567>

Case Study #7- Starbucks Corporation-
Understanding Financial Statements

Abstract:

In this case, I analyzed the financial statements of Starbucks Corporation, one of the largest companies in the world, based in Seattle, Washington. The case called for the analysis of the company's financial statements, by comparing two years of financial performance. In many ways, this case forced me to look at financial statements in the same way and auditor would, which I found very interesting. Reading and analyzing financial statements is a fine practice, that requires the reader to look for certain items of importance. This case provided a small glimpse into the actual role of an auditor analyzing the financial statements of Starbucks. Being able to look at the financial statements of a company with the brank power of Starbucks was an interesting experience in totality.

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?

i. At its core, Starbucks is a retailer and wholesaler coffee company in the business of turning its raw product of coffee beans into coffee. Starbucks also sells tea as well as other beverages in addition to a variety of food options, mainly aimed at delivering a quick, sweet dessert or small meal. Starbucks has four main operating segments, which include the 1) Americas, 2) Europe, Middle East, and Africa, 3) China/Asia Pacific, and 4) Channel Development. Based on the company's financial statements, Starbucks is a sales driven business and makes its money through the sale of its product. This aspect of its operation is essential to its profitability, and Starbucks markets itself by offering a comfortable atmosphere for those traveling from home to work.

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

i. Starbucks prepares a Consolidated Statement of Income, which includes net income and unrealized gains and losses, and is separate from the income statement because its elements are unrealized. In addition, the company prepares an Income Statement, which it calls a Consolidated Statement of Earnings. The balance sheets that Starbucks prepares are called Consolidated Balance Sheets. The statements of cash flows are referred to as Consolidated Statements of Cash Flows and the statements of equity are referred to as Consolidated Statements of Equity. The term consolidated refers to the reporting of financial statements for Starbucks and its subsidiaries, meaning that the company creates financial statements that refer to the company as one entity. Consolidation also refers to investments over which Starbucks can exert significant control.

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

i. Publically traded companies, incompliance with SEC regulations, are required to create an income statement, balance sheet, statement of cash flows, and a statement of stockholder's equity. Starbucks files its financial statements under the Exchange Act of 1934 in the 10-k form. According to SEC regulation, companies must file financial statements within forty-five days of quarter end and within ninety days of year-end.

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

i. According to Item 9a of the notes to the financial statement, management is responsible for maintaining adequate internal controls over financial reporting. Proper internal controls help to ensure reliability in financial reporting in the financial statements, and that all information is accurate. The potential users of financial statements would be management, to make decisions about the future of the company. In addition, shareholders would be users of financial statements, so that those with a financial interest in the company can have a clear picture of how the company is performing financially. Other potential users of financial statements could be the government and those institutions responsible for taxation, as well as potential creditors, interested in the company's financial performance to determine whether or not to finance Starbucks through credit.

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?

i. Deloitte and Touche LLP, out of the firms Seattle office, are the external auditors of Starbucks, responsible for ensuring the materiality of Starbucks' financial statements and accuracy in reporting. The two opinions included at the end of Starbucks' notes to the financial statements include one in which the firm explains that Starbucks reported its financial information accurately and that the audit was conducted in accordance with the Public Company Accounting Oversight Board. This part of the

letter is the unqualified opinion of the firm, based on its audit of Starbucks and review of its financial statements. The second part of the letter includes the unqualified opinion of the firm that states that from what the firm can tell the financial statements of Starbucks are free from error and that the company has adequate internal controls in place to prevent misstatements. The opinions are date several months after year-end because it takes a considerable amount of time to examine a company's financials and ensure that information is accurate and presents a full picture of the company's financial performance to stakeholders in the company.

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

Figure 7-1: Starbucks Consolidated Statement of Earnings

Consolidated Statements Of Earnings (USD $)	12 Months Ended		
In Millions, except Per Share data, unless otherwise specified	Sep. 29, 2013	Sep. 30, 2012	Oct. 02, 2011
Net revenues:			
Company-operated stores	$11,793.20	$10,534.50	$9,632.40
Licensed stores	1,360.50	1,210.30	1,007.50
CPG, foodservice and other	1,738.50	1,554.70	1,060.50
Total net revenues	14,892.20	13,299.50	11,700.40
Cost of sales including occupancy costs	6,382.30	5,813.30	4,915.50
Store operating expenses	4,286.10	3,918.10	3,594.90
Other operating expenses	457.2	429.9	392.8
Depreciation and amortization expenses	621.4	550.3	523.3
General and administrative expenses	937.9	801.2	749.3
Litigation charge	2,784.10	0	0
Total operating expenses	15,469	11,512.80	10,175.80
Gain on sale of properties	0	0	30.2
Income from equity investees	251.4	210.7	173.7
Operating income	-325.4	1,997.40	1,728.50
Interest income and other, net	123.6	94.4	115.9
Interest expense	-28.1	-32.7	-33.3
Earnings before income taxes	-229.9	2,059.10	1,811.10
Income taxes	-238.7	674.4	563.1
Net earnings including noncontrolling interests	8.8	1,384.70	1,248
Net earnings attributable to noncontrolling interest	0.5	0.9	2.3
Net earnings attributable to Starbucks	$8.30	$1,383.80	$1,245.70
Earnings per share - basic	$0.01	$1.83	$1.66
Earnings per share - diluted	$0.01	$1.79	$1.62
Weighted average shares outstanding:			
Basic	749.3	754.4	748.3

Diluted	762.3	773	769.7
Cash dividends declared per share	$0.89	$0.72	$0.56

Consolidated Statements Of Earnings (USD $)	Common Size Consolidated Statement of Earnings	
In Millions, except Per Share data, unless otherwise specified	**Sep. 29, 2013**	**Sep. 30, 2012**
Net revenues:		
Company-operated stores	79.19%	79.21%
Licensed stores	9.14%	9.10%
CPG, foodservice and other	11.67%	11.69%
Total net revenues	100.00%	100.00%
Cost of sales including occupancy costs	42.86%	43.71%
Store operating expenses	28.78%	29.46%
Other operating expenses	3.07%	3.23%
Depreciation and amortization expenses	4.17%	4.14%
General and administrative expenses	6.30%	6.02%
Litigation charge	18.70%	0.00%
Total operating expenses	103.87%	86.57%
Gain on sale of properties	0.00%	0.00%
Income from equity investees	1.69%	1.58%
Operating income	-2.19%	15.02%
Interest income and other, net	0.83%	0.71%
Interest expense	-0.19%	-0.25%
Earnings before income taxes	-1.54%	15.48%
Income taxes	-1.60%	5.07%
Net earnings including noncontrolling interests	0.06%	10.41%
Net earnings attributable to noncontrolling interest	0.00%	0.01%
Net earnings attributable to Starbucks	0.06%	10.40%
Earnings per share - basic	0.00%	0.01%
Earnings per share - diluted	0.00%	0.01%
Weighted average shares outstanding:		
Basic	5.03%	5.67%

Diluted	5.12%	5.81%
Cash dividends declared per share	0.01%	0.01%

Figure 7-2: Starbucks Consolidated Balance Sheet

Consolidated Balance Sheets (USD $) In Millions, unless otherwise specified	Sep. 29, 2013	Sep. 30, 2012
Current assets:		
Cash and cash equivalents	$2,575.70	$1,188.60
Short-term investments	658.1	848.4
Accounts receivable, net	561.4	485.9
Inventories	1,111.20	1,241.50
Prepaid expenses and other current assets	287.7	196.5
Deferred income taxes, net	277.3	238.7
Total current assets	5,471.40	4,199.60
Long-term investments	58.3	116
Equity and cost investments	496.5	459.9
Property, plant and equipment, net	3,200.50	2,658.90
Deferred income taxes, net	967	97.3
Other assets	185.3	144.7
Other intangible assets	274.8	143.7
Goodwill	862.9	399.1 [1]
TOTAL ASSETS	11,516.70	8,219.20
Current liabilities:		
Accounts payable	491.7	398.1
Accrued litigation charge	2,784.10	0
Accrued liabilities	1,269.30	1,133.80
Insurance reserves	178.5	167.7
Deferred revenue	653.7	510.2
Total current liabilities	5,377.30	2,209.80
Long-term debt	1,299.40	549.6
Other long-term liabilities	357.7	345.3
Total liabilities	7,034.40	3,104.70
Shareholders' equity:		
Common stock ($0.001 par value) - authorized, 1,200.0 shares; issued and outstanding, 753.2 and 749.3 shares (includes 3.4 common stock units), respectively	0.8	0.7
Additional paid-in capital	282.1	39.4
Retained earnings	4,130.30	5,046.20
Accumulated other comprehensive income	67	22.7
Total shareholders' equity	4,480.20	5,109
Noncontrolling interests	2.1	5.5
Total equity	4,482.30	5,114.50
TOTAL LIABILITIES AND EQUITY	$11,516.70	$8,219.20

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

Consolidated Balance Sheets (USD $) In Millions, unless otherwise specified	Common-Size Consolidated Balance Sheet	
	Sep. 29, 2013	Sep. 29, 2012
Current assets:		
Cash and cash equivalents	22.36%	14.46%
Short-term investments	5.71%	10.32%
Accounts receivable, net	4.87%	5.91%
Inventories	9.65%	15.10%
Prepaid expenses and other current assets	2.50%	2.39%
Deferred income taxes, net	2.41%	2.90%
Total current assets	47.51%	51.09%
Long-term investments	0.51%	1.41%
Equity and cost investments	4.31%	5.60%
Property, plant and equipment, net	27.79%	32.35%
Deferred income taxes, net	8.40%	1.18%
Other assets	1.61%	1.76%
Other intangible assets	2.39%	1.75%
Goodwill	7.49%	4.86%
TOTAL ASSETS	100.00%	100.00%
Current liabilities:		
Accounts payable	4.27%	4.84%
Accrued litigation charge	24.17%	0.00%
Accrued liabilities	11.02%	13.79%
Insurance reserves	1.55%	2.04%
Deferred revenue	5.68%	6.21%
Total current liabilities	46.69%	26.89%
Long-term debt	11.28%	6.69%
Other long-term liabilities	3.11%	4.20%
Total liabilities	61.08%	37.77%
Shareholders' equity:		
Common stock ($0.001 par value) - authorized, 1,200.0 shares; issued and outstanding, 753.2 and 749.3 shares (includes 3.4 common stock units), respectively	0.01%	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%

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

i. Total Assets: 11,516.70= Total Liabilities 7,034.40 + Total Equity 4,482.30

ii. Cash and Cash Equivalents, Inventory, and Property, Plant, and Equipment represents Starbucks' major asset accounts. Current Assets are 47.51percent of Total Assets, and Long-Term Assets are 52.49 percent of Total Assets. As a company that sells products such as food and beverages, it makes sense for them to balance current assets with long-term assets. Balancing selling food and beverages with investment in store locations creates reason to have this balance between current and long-term assets.

iii. An intangible asset is an asset that does not have any physical qualities. Goodwill occurs when an outside party buys a business that is already in existence. Basically, goodwill is the value that a company is believed to hold upon purchase. Starbucks would have franchises as intangible assets, as many of its locations are created as franchises. In addition, Starbucks would have copyrights for its products and branding. Starbucks would also have trademarks and trade names for its products as well.

iv. Starbucks is financed primarily by debt. Liabilities represent 61.08 percent of its financing from non-owners, or $7,034.40 million, which means that Starbucks does more of its financing through debt than equity. Such a balance could result in trouble meeting those debt obligations if the company were to fall on hard times.

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

i. Starbucks recognizes revenue at the point of sale immediately upon receiving payment from a customer. Revenues from store cards when the card is redeemed, or when redemption is deemed likely based off of patterns of past customers. With regards to measuring revenue with the use of store cards, the company could opt to recognize revenue with the purchase of a store card, as money has already been spent, because basing revenue recognition based off of the likelihood of redemption could prove risky. As a result, Starbucks' unearned revenue will be inconsistent by use of this practice.

ii. The cost of sale including occupancy cost represents 42.86 percent of its total expenses in relation to revenues. Cost of sales refers to how much Starbucks spend on procurement and production of its products to then sell to its customer. In addition, store-operating expenses make up 28.78 percent of its expenses in relation to total net revenues. Operating expenses include labor costs. Overall, these two expenses represent Starbucks' major expenses.

iii. Operating Expenses and Sales costs all increased, but at a lesser rate than net revenues. Depreciation and Amortization increased as well, which did not have an effect on overall revenue, as Starbucks saw an increase in net revenues of 11.98 percent. The real effect on Net Income came in the form of a large litigation charge of $2,784 million, which was up from $0 in the previous year.

iv. When a litigation expense occurs, it must be disclosed in the footnotes of the financial statements as well as separately within the body of the financial statements. Looking at the financial statements can provide the source of the litigation charge. Therefore,

Starbucks is required disclose the litigation charge separately under Operating Expenses, as it is not simply a general and administrative expense that occurs regularly.

v. The company was overall profitable in 2013; however, Starbucks saw a steep decline in profitability in 2013 as compared to 2012. The percentage drop with relation to net revenues went from 10.4 percent to 0.06 percent, possibly due to the litigation charge that resulted in a large, unforeseen expense.

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

i. Net cash from operating activities includes cash flows generated from operating activities, which mainly include a company's core business activities. Net earnings represents cash retained by the company in its operations. Depreciation and Amortization also contributes significantly to the cash earnings difference. In general, a company would like the ratio of net earnings with relation to net cash provided by operating activities to be higher. In 2012, Starbucks' ratio of net earnings to net cash provided by operating activities was 79.11 percent, whereas the ratio in 2013 was merely 0.3 percent, representing a significant drop in the cash provided by operating activities and the level of earnings in the company. The litigation charge could be a large factor in this drastic change. However, this low ratio does present red flags. Even though deferred taxes increased dramatically to help offset the litigation charge, the ratio of earnings to cash provided by operating activities was still very low.

ii. The level of expenditures for property, plant, and equipment for 2013 was $1,151.20 million. This total represents the amount of funds used in the purchase of new property, plant, and equipment for the company.

iii. Starbucks paid $628.9 million in dividends in 2013. However, in the Statement of Equity, the company declared $668.6 million in dividends, showing a difference of $39.7 million in the amount of dividends declared and the amount of dividends paid.

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?

i. In the notes to the financial statements, Starbucks outlines the need for estimates in reporting assets, liabilities, equity, and revenues. Accounts highlighted in the notes that require estimates to provide values include assets and goodwill impairment, which state that the value of holding an asset can create a loss if its fair value suddenly declines below its book value. As a result, it can be difficult to determine exactly the amount of an impairment, because the company could hold the asset until it recovers or simply write it off, creating ambiguity as to the value of an impairment with regards to assets and goodwill, which is why estimates are required. In addition, Accounts Receivable requires estimates, as it cannot be guaranteed that all of that money will be received and bad debts must be estimated. Depreciation must also be estimated to determine the decline in property, plant, and equipment. Starbucks also estimates revenues based on the likelihood of redemption of gift cards, which affects the unearned revenue account, as the company must estimate the amount of revenue that will be earned from the redemption of gift cards. Cash and cash equivalents is an account that would not use estimates, as well as current liabilities and long-term liabilities.

Case Study #8- BP p.l.c.- Contingencies

Abstract:

When beginning this case, I was familiar with the events that occurred as a result of the Deepwater Horizon oil spill, which resulted in thousands of gallons of oil being poured in the Gulf of Mexico. I found it very intriguing to read more into the financial impact of the event and how different industries in the region were affected by such a catastrophic event. In addition, it was interesting to learn how BP had to deal with the liabilities incurred as a result of the event, as well as the recording of contingent liabilities in general. As normal contingent liabilities due to the use of products are part of normal operations within a company, such as the use of a telescopic joint, the estimation of liabilities from an event such as Deepwater Horizon can make determining the liabilities that may arise from such an event so difficult. As a result, BP had to accrue a significant amount of expenses as well as record a large amount of liabilities. In total, this case helped me learn a lot with regards to financial reporting and the recording of contingent liabilities, and when a company should incur and record contingent liabilities. Furthermore, I learned that in general, gains or assets are not recorded, even if the possibility that assets will arise or that gains will occur is probable. This case was very informative with regards to the effect on industries and the potential for liabilities due to ensuing litigation against companies, as well as the process for reporting contingent liabilities.

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

A contingent liability is a liability that occurs when a company has potential obligation that may occur in the future, but cannot be measured reliably. In a situation where a contingency is probable and can be reasonably estimated, the company records the liability in the financial statements. If one or more of the conditions is met, then the company records the liability in the footnotes of the financial statements or not at all. An example of a contingent liability could include a lawsuit, product warranties, and pending investigations are all examples of contingent liabilities. A contingent asset occurs when a company may have an asset in the future because of circumstances that are out of the company's control. Companies do not record contingent assets, even if they are probable to become material.

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 heaves and offset on drilling vessels and is sold with a two-year warranty against defects. From BP's perspective as the purchaser of the telescopic joint, what is a product warranty? From the perspective of GE Oil and Gas, the manufacturer of the telescopic joint, what is a warranty?**

From the perspective of BP, a product warranty is the right of the buyer, which is BP in this case, to return or demand repair of a defective item, in this case a telescopic

joint. BP holds the right to claim that a product is defective and return it to the manufacturer. BP would not record the warranty in its book, as it is not considered a contingent liability for the purchaser with a warranty on a product. The liability must be matched to the period of sale. In the case of GE Oil and Gas, a product warranty is a contingent liability that must be estimated to record potential liabilities arising from potentially defective goods. A product warranty requires GE to repair or potentially replace any goods that are defective throughout the life of the warranty, and must therefore be estimated using the potential amount of defective products.

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?**

A company needs to make judgments to determine the quantity of defective products, upon which a warranty claim will be made. That is, the company should record contingent liabilities if it is even remotely possible that a liability will arise. A claim resulting from damages from the Deepwater Horizon oil spill differs from a claim on equipment in the sense that it is harder to estimate the amount of a liability that can result from damages, as such as disaster can cause damages far into the future. Therefore, a company must make its best effort to accurately estimate the liabilities that will arise. Whereas, on the other hand, contingent liabilities are recorded in the place of a claim on equipment, however, it is much easier to estimate the level of defective product in the case of equipment, making liabilities more reliable to estimate. Based on past experience,

a company can more accurately estimate liabilities on a piece of equipment. However, with damages from a colossal disaster such as Deepwater Horizon, estimating liabilities can be much more complicated, as such an event is remote and completely unexpected.

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

Some of the estimates that BP must make include contingent liabilities from lawsuits arising from damages to a multitude of industries around the affected area. BP announced, as of January of 2018, that it would incur a 1.7 billion dollar expense for the oil spill. As of July of 2016, the company had paid over 61 billion dollars in court fees, penalties, and cleanup costs. Such a remote disaster makes estimating liabilities extremely difficult, but in general, a company should opt to report the highest estimable liability possible if there is even a small possibility that a liability will arise.

As a result of the BP oil spill, which was significantly larger than the Exxon Valdez spill, industries such as the fishing industry took a tremendous hit, as some fish populations were reduced by as much as twenty percent. The oil industry was also affected greatly by the incident, as regulation in the industry increased significantly, and drilling leases were even temporarily suspended until the government had time to review the safety regulations of oil companies. This regulation forced oil companies to significantly review safety precautions. In addition, a ruling from a federal judge asserted that BP had been negligent in its safety policies and response to the oil spill. The event caused a cataclysmic shift in the oil industry that changed the way regulations were enforced against oil companies. In addition, the insurance industry took a tremendous hit,

as only four companies were large enough to insure the risks involved in the spill. Insurance companies saw tremendous losses, with no way to insure such an extraordinary and disastrous event. The tourism industry took a major hit as well due to the oil spill, as beach hotels saw guests cancel reservations because of the potential for damage to beaches because of the spill. The losses due to a decrease in tourism in the gulf region was estimated at 23 billion dollars, which provides another example of a potential contingent liability for BP, as the company had to incur an expense to make an effort to contribute to the recovery of tourism in the region. The real estate industry also saw a negative effect due to the oil spill as well, as prices decreased significantly as a result.

These entities, such as fishing companies, real estate companies, and tourism companies all had the right to pursue litigation against BP, as their central operations were directly affected by the oil spill. However, questions do arise as to the boundaries of the damages and how far reaching should the affected area be. In addition, Transocean was the owner of the rig and Halliburton was part of the operation of the rig as well. In this case, the affected parties should have the ability to sue these companies as well for gross negligence. If the U.S. Justice Department was able to prove that gross negligence had occurred, wherein BP, as well as the other parties involved, ignored warning signs of a potential accident, then a lawsuit would then be warranted. As a result, BP would likely have to respond accordingly by recording contingent liabilities for potential litigation and penalties due to its negligence and role in the oil spill.

Case Study #9- The Wendy's Company- Equity Method Investments

Abstract:

This case dealt with topics that I had recently encountered in Intermediate Accounting, how to account for investments under the equity method. In this case, we examined The Wendy's Corporation, and its TimWen joint venture, in which Wendy's exerted significant influence over its investee, leading to accounting for TimWen's dividends and income under the equity method. This case forced me to delve into the financial statements of the company and analyze how Wendy's accounted for its investments and the TimWen venture, and where events such as net income or the distribution of dividends affected Wendy's financial statements. This case helped to apply a real-world scenario to a concept covered in my coursework. As a result, I found it very interesting to notice the real effects that accounting practices such as the equity method have on the financial statements of a company like Wendy's. As analysis of financial statements is a key skill in the accounting industry, completing cases such as these serve the purpose of both showing situations in which topics covered in accounting coursework appear in real life, as well as the real life application of accounting for investments under the equity method and looking deeper into a company's financial statements. Being able to look at a company such as Wendy's, one that I often frequent as a customer, provides an interesting opportunity to examine a company in a new light and analyze how companies account for investments. In this case, the case dealt with an equity method investment on the part of Wendy's in the form of the TimWen venture, which offered a glimpse into the accounting treatment that companies use in preparing financial statements.

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

i. The concept of a joint venture involves two companies pooling their resources and expertise to achieve a business objective. Reasons for entering this type of business arrangement could include expansion, development of new products, or expanding into a new market. Wendy's likely entered into the TimWen joint venture to expand its resources and expand overseas into the Japanese market. By entering into a joint venture, a company could acquire any or all of the following enhancements to its business: more resources, greater capacity, increased technological capabilities, and access to established markets and distribution channels.

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

i. Under the equity method, a company is exerting significant influence over another company, which generally indicates holdings in the company of twenty to fifty percent of the investee company. The investor initially records the investment at the price of the shares acquired, but adjusted the amount each period for changes in the investee's net assets. For example, an initial investment in a company would lead to a debit entry in an investment account, with a credit entry in the cash account. Any dividend activity results in a debit to the cash account, but a credit reduction in the investment account, as the paying of dividends results in

the usage of assets for the investee, which must be adjusted proportionally by the investor. Any income for the investee is marked with a debit in the investment account, to show the increase in assets of the investee, with a credit to an investment income account.

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

i. If the investment of a company purchasing shares in another company exceeds the investor's share of the Book Value, then goodwill is created. Half of the amount of excess is written up to Fair Value, while the remainder is written up as goodwill. The excess amount is not depreciated, as there is a charge for the depreciating this excess.

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

i. Wendy's did not include a specific section for equity investments in its consolidated balance sheet, but included a section for its total amount of investments, less the loss on the investment in Japan, totaling $113, 283, in 2012, and $119,271 in 2011, including the joint venture in Japan. The joint venture with Tim Horton totaled $89,370, which is reported in the "Investments" category under the consolidated balance sheets. The loss for the joint venture in Japan in 2012 was included in the "Other Liabilities" section of the balance sheet, as the company discloses in its notes.

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?

i. The amount reported as investments for TimWen is $89,370 for 2012. However, TimWen reported $70,565 in equity for 2012. Half of that amount, or $35,282.50 would be Wendy's share of equity under the equity method. The difference between the amount reported under investments and Wendy's share of equity in TimWen represents the acquisition premium paid by Wendy's, where the initial investment exceeded the value of TimWen's net assets. As a result, the remainder of excess is written up to Fair Value of TimWen's net assets and the remainder is allocated to Goodwill.

f. Consider the information disclosed in Note 8 regarding Wendy's investment in the

TimWen Joint Venture.

i. The equity method investment appears in "Other Operating Expenses, Net." In 2011, $10,571 was Wendy's share of the TimWen investment's net earnings before taxes, and $10,551 in 2012, as reported in the notes to the financial statements.

ii. The journal entry for Wendy's share of TimWen's earnings is as follows:

Equity Investments 13,680

  Equity income 13,680

iii. The amount of amortization is $3,129. The journal entry to record amortization is as follows:

Investment Income 3,129

  Equity Investments 3,129

iv. The dividends received in 2011 and 2012 were $14,492 and $15,274, respectively, which is disclosed in the notes to the financial statements, showing the dividends received from the joint venture under "Distributions Received." The journal entry to record dividends for 2012 under the equity method is as follows:

Cash 15,274

  Equity Investments 15,274

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

i. Equity income is a part of net income, but it was not received as cash as a part of TimWen's income, so it must be subtracted from net income. Therefore, a

negative adjustment must be made to arrive at net cash from operating activities, thus explaining the negative adjustment of $8,724 in the operating section of the Cash Flows Statement. This value should be subtracted from net income in order to get net cash flow from operating activities as reported on the Statement of Cash Flows.

ii. A positive adjustment was made in the amount of $15,724, which represents Wendy's portion of dividends received from the TimWen venture. This is a direct cash receipt, so it must be added back to Net Income. The amount added is an inflow of cash, and is why it is a positive adjustment to the Cash Flows Statement.

Case Study #10- Johnson & Johnson-
Retirement Obligations

Abstract:

In this case, the focus shifted to accounting for pensions, with a specific focus on Johnson & Johnson's pension practices. This case was very relevant to my current coursework considering that pension were a prominent topic in the most recent test in intermediate accounting. This case forced me to delve into the company's financial statements and analyze how different actions, such as service costs, interest costs, and return on plan assets, affect the pension plans of an employer. Gaining an understanding of pensions through coursework in intermediate accounting and then applying that knowledge to an actual company provides a great groundwork and a new level of understanding for the material. It was interesting to see how a company such as Johnson & Johnson funds its pension plans and the way in which its Projected Benefit Obligations and Plan Assets are affected over the curse of years of operation. It was also very intriguing to see just how much funding goes into retirement plans and the level of investment required by large companies, as Johnson & Johnson held well over ten billion dollars in plan assets as of 2007. All in all, seeing the funding of pension plans in a real-life scenario is interesting and provides a deeper understanding to the topics covered in my coursework. As I enter into my future career path, I undoubtedly will enroll in a retirement plan with my employer. Therefore, gaining an understanding of how these plans work and how contributions are made to the plan provides an interesting insight into what I will be looking at as I begin my career. Johnson & Johnson is also a very large company with large retirement plan operations, so this case gave me the chance to see a large pension plan that a company has to fulfill as part of its obligations to its retiring employees.

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

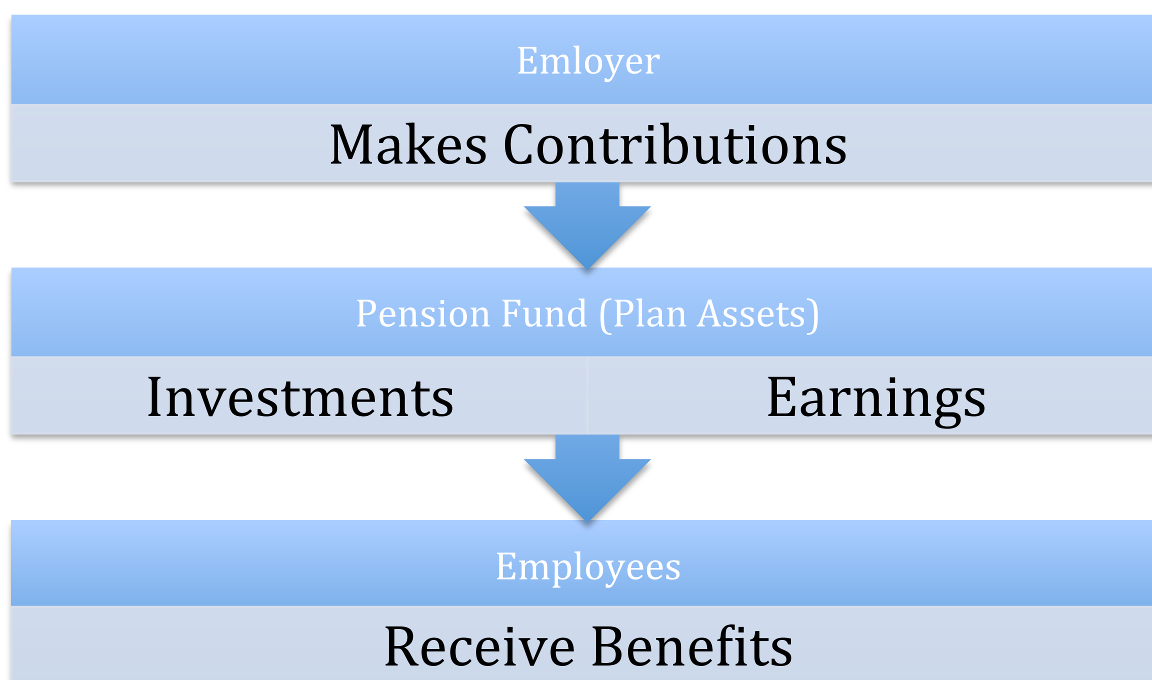
i. Defined contribution plans call for employees to contribute to a pension trust in a certain amount each period, based on a formula. This type of plan defines only the contribution made by the employer, but makes no promise as to the benefits paid out to employees. The size of the benefits ultimately collected depend on the amount originally contributed to the pension trust, the income accumulated in the trust, and the treatment of forfeitures of funds caused by early terminations of other employees. A defined benefit outlines the benefits that employees will receive upon retirement. The company must determine the contribution that must be made today to meet commitments. As long as the plan continues, the employer is responsible for the payment of the defined benefits. This type of plan causes more risk because employers must contribute enough to meet the cost of benefits that the plan defines. Johnson & Johnson uses defined contribution plans, defined benefit plans, and termination indemnity plans for its fulfillment of pension obligations.

ii. Retirement plan obligations are liabilities because it is an accrual of an amount owed to employees in the future. As liabilities are defined as something that is owed, a retirement plan obligation is an accrual of benefits owed to employees in the future, and therefore is accounted for as a liability.

iii. The assumptions that are made to account for retirement plan obligations are

called actuarial assumptions. Actuaries are individuals that are trained to predict future events and the ensuing financial effects. Actuaries make predictions of mortality rates, early retirement frequency, future salaries, and any other factors necessary to operate a pension expense.

Figure 10-1: Johnson & Johnson Retirement Plan Flow Chart

iv. 

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

i. Service costs are the expenses caused by the increase in pension benefits payable to employees for an additional year of service. These costs increase the projected benefit obligation of the company. Interest cost is the amount of interest accrued on the projected benefit obligation as with any discounted debt. Actuaries help to

choose the interest rate, which is referred to as the settlement rate. Actuarial gains and losses occur as a result of unexpected changes in pension expense that result from a sudden change in the fair value of plan assets or changes in actuarial assumptions that affect the amount of the projected benefit obligation. These gains or losses are recorded on the Comprehensive Income Statement. Benefits paid to retirees are the cash amount paid o employees that have retired. The payment of benefits simultaneously reduces the projected benefit obligation, as the company has less of an obligation from the payment of benefits, as well as plant assets, as benefits are paid with the money stored in plan assets to pay retirees.

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

   i. Actual return on pension assets is the increase in pension funds from interest, dividends, and realized and unrealized changes in the fair value of the plan assets. A higher actual return than expected return results in a gain and means the plan was overfunded. A return that is lower than expected return means that the plan was underfunded. Actual return on pension assets decreases pension expense and increase pension assets. Company contributions to the plan are the required amount that the company must place into pension assets in order to meet future commitments. The payment of contributions decreases the cash account and

increases the pension asset account. Benefits paid to retirees are the monetary amounts paid to employees that have retired. Payment of benefits reduce the projected benefit obligation, as it reduces the obligation to pay employees, and decreases pension assets as well, as the money used to pay benefits comes directly from the pension asset account.

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

   i. The dual component of return on plan assets that exists in both pension expense and pension plan assets has the opposite effect on each of the accounts. Actual return decreases the pension expense account and arises from interest, dividends, or changes to the fair value of plan assets. This reduction results because when plan assets experience a return, and the amount of funding for the pension plan increases, thus reducing the necessary pension expense. Actual return increases pension plan assets, because when interest is accrued, dividends are received, or the fair value of the assets increases, then the company's pension plan has more funding. Pension expense uses the expected return to reduce market-induced volatility in the income statement.

e. **Omit**

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. The company reported $379 million in pension expense in 2007, as it discloses in its notes to the financial statements.

ii. The entry to record service cost and interest cost is as follows:

Pension Expense $1,253 million

Projected Benefit Obligation $1,253 million

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. The value of Johnson & Johnson's retirement plan obligation is $12,002 million. This value represents the future obligations that the company has to its employees as a part of their pension benefits. This number is reliable to a point, as it includes actual costs incurred during the year, such as interest and service costs. However, due to changes that may occur unexpectedly in future periods, the level of projected benefit obligations is subject to change.

ii. The pension-related interest cost for the year in 2007 is $656 million, which is calculated based on the beginning balance for the year for 2007, which is the same as the year-end balance in 2006 of $11,660 million. PSO amendments are $14 million. By dividing 656 by 11,660, it can be determined that the settlement rate is approximately 5.62 percent. This rate seems reasonable, because it falls within the domestic and international rates disclosed in the footnotes.

iii. Johnson & Johnson paid $481 million in benefits in 2007. Based off of its disclosure of pension amounts in the balance sheet, Johnson & Johnson did pay cash for these benefits. The payment of benefits results in a decrease in the projected benefit obligation and a decrease in the pension asset account as well.

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

i. The value of Johnson & Johnson's plan assets at the end of 2007 was $10,469 million. This value represents the fair value of the company's plan assets, which represents the total funding of its retirement fund, and the fund by which the company pays benefits to its retired employees.

ii. Actual return on plan assets for the company for 2007 was $743 million, compared to the expected return on plan assets of $809 million. This difference means that the plan was underfunded by $66 million. This value is significant and must be amortized over the remaining service life, and a loss will be recorded for 2007. The expected return reflects the economics of the company more than the actual return, because Johnson & Johnson's retirement plan was underfunded in 2007, meaning that more return on plan assets is needed to meet obligations.

iii. In 2007, Johnson & Johnson contributed $317 million to its plan assets, and its employees contributed $62 million. Compared to 2006, the company's contributions increased by $48 million, from $259 million, and the employee

contributions increased by $15 million, up from $47 million.

iv. In 2007, Johnson & Johnson's U.S. retirement plans were made up of 79 percent equity securities and 21 percent debt securities. Additionally, the company discloses that the fair value of the common stock held in its plan assets was $462 million in 2007, making up 4.4 percent of total plan assets.

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

i. At December 31, 2007, Johnson & Johnson's retirement plan was underfunded by $1,533 million, as the company discloses in its disclosures on its pension plan disclosures. At December 31, 2006, the plan was underfunded by $2,122 million. The funded status appears on the balance under "Employee Related Obligations." Note 13 discloses additional information on what this account title means and discusses the types of pension plans that Johnson & Johnson uses. The funded status information is found in the information related to the company's pension plans on page 62.

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

Abstract:

Before this case, I had never previously considered the implications that following the balance sheet approach may have in financial reporting for companies, and how the shift towards the balance sheet approach in the mid 1970s dramatically changed the way in which companies perceive value. However, reading this article forced me to consider why a company would measure its value in terms of its assets, as opposed to its earnings and the value a firm adds for its shareholders. In its true essence, the goal of a profit-driven business is to advance expenses to create earnings and thus make the company profitable. However, with the balance sheet approach, the FASB has now stated that a company must define assets before it defines earnings. Under the current method, ambiguity is created, as the FASB defines assets in terms of earnings, making the valuation of assets unclear and by definition, places value on earnings over assets. Especially with the rise of intangible assets, companies are now incentivized to overvalue intangible assets such as goodwill, to make the value of the company appear more substantial on the balance sheet, when a company should be focused on generating earnings. I had not at all considered the ramifications of such a Conceptual Framework, but this article altered my way of thinking to the stance that accounting needs to reflect the true purpose of a business and the economic reality of operations of a company, which are to generate earnings. As a result, I believe the FASB needs to alter its approach to accounting so that financial reporting can become more efficient and reflective of a company's operations. This case also forced me to think about how the current standards in place will appear in my work life. Although standards may be flawed, the job of accountants is to accurately report information and follow the

standards that are in place, meaning that no matter how I feel about the issue, it will be my duty to fulfill my role ethically and in accordance to the current Conceptual Framework.

Summary:

This article, published by the Columbia Business Center for Excellence in Accounting and Security Analysis, outlines the shortcomings of the current construction of FASB standards that govern the way in which companies implement accounting principles and report in their financial statements. The opening of the article states that around thirty years ago, as of 2007, the FASB switched over to balance sheet accounting, where the focus of reporting was the value of a company's assets. Therefore, the FASB placed more value on assets than earnings, which the writer argues is the main point of existence for a business. The writer asserts that earnings should be the central figure in financial reporting, and the way in which companies report on financial statements should reflect the usefulness and prospective value of increasing earnings. In essence, the shift away from the income statement approach will certainly lead to faulty accounting. The first portion of the publication explains the historical detail of the shift to the balance-sheet approach, and how, in the mid-1970s, the FASB regarded the balance sheet approaches and the income-statement approaches as at odds with each other, and that one had to be chosen over the other, so as to avoid a confusing compromise between the two. Finally, a decision was made that earnings was a change in value concept, which is impossible to define; accordingly, a balance sheet approach would be adopted. The writer continues to point out that even with this switch, FASB standards still have conflicting messages, as Concepts Statement 1 places a huge value on a firm's earnings as essential for investors and creditors in looking at the performance of a firm.

The writer then shifts into a critique of the balance sheet approach to accounting, by asserting that this approach would make sense if the purpose of a firm was to acquire and grow

assets. However, the primary goal of a firm is not simply to acquire and grow assets, because "the stock of assets only exists because of the continuous process of asset renewal and sacrifice" (10). The article goes on to establish that the true purpose of a firm is expenses to earn revenues, as revenues are the most essential part of a firm's to existence. Everything in the firm revolves around the purpose of generating revenues. Most managers and financial analysts prefer the income-statement approach, as it is the method by which most businesses operate. The way in which analysts use predictions, an income statement is generally what is prepared. As the publication stresses, the balance sheet approach takes assets as stores of value, and "diverts attention from operations, which are key to firm success and value" (12). Furthermore, the writer points out that the FASB claims that assets must be defined before earnings can be defined, but then goes on to define assets in terms of earnings. This contradiction created by the FASB is the central point of the argument against the balance sheet approach in this publication. In short, the writer asserts that assets can be difficult to attribute to the output produced by a firm's operations, making the balance sheet approach inherently flawed.

The next portion of the article states that the balance-sheet approach has hurt the value of using earnings to make future predictions about firm performance. Partly because of the emphasis put on the balance sheet, earnings have become more volatile as a result, and potentially useless for the future outlook of a firm. The writer calls for the accounting industry to recognize the difference between the economic and financial markets, and that accounting must reflect the real economic activities of a business. The article also calls for the combination of operating and investing activities to fall under one category, to help create a better alternative approach to accounting that best reflects the true purpose of a business. As a result, the income statement should clearly identify the difference between earnings and regular operating activities.

Accounting should, as stated by the article, reflect the economic reality that firms are managed based off of the income statement. In totality, the paper makes the claim that the cornerstone of financial reporting should be revenue recognition and matching, and that the current method is inherently flawed and lacking in efficiency.

Responses to Questions:

Prior to reading this article, I had not previously considered the implications of a change in the way in which the FASB values financial reporting, and what aspects of financial reporting are most essential. I realize that the purpose of a firm is to maximize profits and increase value for shareholders. This truth in the goal of a firm makes the income-statement approach to financial reporting seem to be the far superior method, which results in questions as to why the FASB would switch to the balance-sheet approach in its focus in financial reporting. As the paper asserts, a firm's objective is not to acquire assets and grow their financial value, as acquiring assets is a means by which to further the economic scope of a company. The writer uses Microsoft as an example, stating that using the value of Microsoft's assets does not adequately justify the profitability of the company and its proclivity for generating earnings. Managers and financial analysts use current earnings as a way to predict future earnings and predict how a firm should act in the future so as to maximize earnings. The concept of using a balance sheet and the total value of a firm's assets to analyze economic performance seems inefficient upon further review. I had not previously considered that the balance-sheet approach indeed does carry with it various inefficiencies that make it a less realistic method of reviewing economic performance of a firm. As it is a firm's goal to maximize earnings, the fact that the FASB switched to a method that places value on the assets seems questionable and unreasonable. After reading this article, I agree with the writer in the sense that accounting must shift to reflect

the economic reality of a firm's purpose and placed value on revenue recognition and matching, as assets are used and sacrificed with the purpose of boosting earnings in mind. The article also highlights the contradictory nature of some of the concepts in FASB standards. For example, the FASB claims that assets must be valued before earnings can be valued, but then proceeds to define assets in terms of earnings. By stating that assets serve the purpose of bringing future benefits, the FASB is essentially saying that assets are a means to an end to generate earnings. Therefore, the balance sheet approach is inherently flawed, and does not accurately reflect the economic purpose of a profit-driven firm. I believe that accounting should alter to a method more focused on earnings and place on emphasis on the importance of earnings to a firm. I completely agree with the author of this article, that the methodology by which firms report their financials is flawed as long as the FASB places an emphasis on the balance sheet and the value of assets, as opposed to the central operations of a firm, which are profit-driven. The FASB should also make efforts to clarify how companies should report, as defining assets in terms of earnings, then turning around and saying that the true emphasis of financial reporting should be on the balance sheet is unclear and flawed. Therefore, because earnings and the advancement of expenses to generate earnings is the true purpose of a business, accounting should be tailored around emphasizing the economic reality of a firm's true purpose. If accounting continues to focus on the balance sheet, earnings may become a useless number in terms of projecting into the future and decision-making. As a result, I believe that accounting should consider a shift towards bringing the emphasis of financial reporting back to earnings.

While I do believe that accounting should evolve to place an emphasis on earnings instead of balance sheet assets, FASB standards are the governing law of accounting, which means that based on ethical standards, they are to be followed. In certain instances, I may be

faced with situations in which I personally do not agree with the way in which FASB standards focus on the emphasis of the balance sheets and analyzing the performance of a firm through the value of its assets. However, as an accountant, it will be my duty to keep in mind those standards that govern financial reporting and to adequately adhere to those standards no matter what. In a real-life scenario, I could be faced with a situation in which a controller of a company places pressure on me as an auditor to inflate the value of a company's assets so as to help improve earnings numbers. As a controller of a company may want to boost earnings to appease shareholder expectations, and because accounting standards promote the balance sheet approach, a client could potentially want to see inflated asset value to boost earnings number and boost the overall value of the firm. However, accountants have a duty to adequately follow FASB standards, even if there are areas for the standards to be improved. In addition, as the article explains, the rise of intangible assets means that firms have begun to place high value on intangible assets, which presents a level of ambiguity on how to value them. However, as FASB standards follow the balance sheet approach, there is an incentive created for firms to inflate the value of their intangible assets in order to provide the illusion of enhanced value.

In another case, because the balance-sheet approach places pressure on firms to have highly valued assets, I could be faced with a situation where a firm is attempting to alter the value of its intangible assets, which are inherently more difficult to value and can inflated to increase the value of assets on the balance sheet. Consequently, I could face a situation where a client is pressuring me as an auditor to report significant raises in the level of intangible assets for the company, resulting in a large increase in the value of a company's assets and value based on the balance sheet. However, I will be obligated to accurately report the value of the company and the value of its assets to the best of my knowledge through an audit. The ambiguous nature

of valuing certain assets and the rise in prominence of intangible assets has ultimately complicated the nature of financial reporting on the balance sheet with regards to intangible assets. However, the standards are in place and must be followed.

Another way in which this article will impact me in the accounting field would be with regards to the increasing volatility in earnings. With the balance sheet method, earnings have become increasingly volatile and may prove to be useless in making projections about the future of a company. However, accountants are supposed to be able to analyze financial findings and make recognize trends. However, as the Conceptual Framework revolves around the value of assets, it will be my job as an accountant to adapt accordingly, and find ways to make assumptions based off of the financial information of a given client. In summary, while the current framework for accounting, with emphasis on the balance sheet approach, has its flaws, the role of an accountant includes adherence to ethical standards and accuracy in reporting information for a company, although pressure may exist to bolster true value of a company for the benefit of a client. Regardless of how I may feel about the current approach to financial reporting, it will be a part of my job to follow FASB standards and to ensure that companies accurately report information on financial statements. I will be tasked with avoiding pressure to enhance a company’s asset value or adjust earnings to assists a client if such a situation arises, as the standards that govern accounting law are to be followed.

Case Study #12- Google, Inc.- Earnings Announcements and Information Environment

Abstract:

With this case, I had the opportunity to analyze Google, a company with which I have been familiar my entire life and use almost daily. It was very interesting to delve into the financials of this juggernaut tech company and see how Non-GAAP financial reporting is used to report figures for the company. Non-GAAP reporting is a significant portion of the way in which Google transmits information to its investors, as may companies believe that reporting Non-GAAP figures more accurately represent the results of the company's central operations, as financial reporting that does not follow GAAP excludes expenses that are infrequent and apart from the central operations of the company. In addition, this case was also an interesting opportunity to observe the way in which earnings reports affect stock prices. For a well-performing company such as Google, quarterly earnings reports generally relate to a strong increase in stock price. With the company's press release on January 30, 2014, the stock price of the company increased significantly and the market had an overall strong reaction. This case showed me the impact a positive news report by a company can have on the market price of a stock. The market tends to react in a positive or negative way to the year-end reports of a company. As Google reported strong growth across the board, the market reacted positively to the company's press release. A company's press releases and disclosures of information can have a major impact on the reaction of the market and the stock price of a company. With a company with such a high profile as Google, the release of positive information can cause a surge in investor confidence that can lead to a significant increase on the company's stock performance. Overall, this case was very informational in displaying how significant Non-GAAP financial reporting and the release of information through the press can impact the overall investor confidence in and performance of a company.

a. 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. (Part H)

i. With Non-GAAP financial reporting, the goal of the company is to present information that would provide investors with a more clear understanding of the business and its performance. This method of financial reporting outside of the official financial statement of the company has been around since the 1960s. Common examples that companies report are EBITDA, or earnings before interest, taxes, depreciation, and amortization, and EBIT, or earnings before interest and taxes. These measures serve to provide a level of understanding of the company's financials before such deductions that are required by GAAP. In its reconciliations of Non-GAAP results of operations, Google reports its GAAP income as $3,376 million and its Non-GAAP income as $4,096 million. These adjustments come from the elimination of stock-based compensation expense and restructuring and other related charges, as the company discloses in its notes. In addition, Google reports these figures with the exclusion of the tax effects of these expenses and losses from discontinued operations. As a result, Google reports a significantly higher net income figure from Non-GAAP reconciliations. I agree with the adjustments made by Google to report this net income figure. The expenses that Google excludes from its Non-GAAP net income figure are not recurring or central to the operations of the company, as it discloses, and relate to infrequently occurring expenses, such as stock based compensation expenses and restructuring expenses. Additionally, losses from discontinued operations are not

regularly occurring and represent infrequent charges as well. The tax effects should also be eliminated as well. This Non-GAAP amount for net income also provides investors another level of clarity as to the true performance of the company, as it shows the performance of the company with only its frequent expenses that are part of the central operations of the company. Google likely should report stock compensation expense, as it is recurring and is an operating expense, but is justified in its exclusion of the other figures. (Part h-ii)

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

i. In general, when analyzing Google's stock price, quarterly earnings reports generally result in a rise in stock price, especially if earnings exceed estimates and perform well. In quarters one and two, stock price rose slightly in response to quarterly earnings reports. Likely due to earnings either performing in proportion to estimates. In quarter three, stock price saw a massive surge in response to earnings reports, which could be attributed to the company's earnings outperforming estimates. In quarter four, stock price again rose in response to earnings reports. Over the course of the year Google saw its stock price consistently rise throughout the year and generally surge in response each of its quarterly earnings reports.

ii. Over the course of 2013, Google's stock return was consistently higher than the Nasdaq average, except for one dip below the average early in the year. From February to October, Google's stock return was slightly larger than the Nasdaq average. However, at the point of reporting the earnings for quarter three, the

company's stock return rose significantly above the Nasdaq average and remained consistently higher through the February 2014 cutoff of the graph. These numbers indicate a strong return from Google's stock and an overall strong performance for the company, as stock return is a significant indicator of overall performance for a company.

iii. The stock price rose around one hundred dollars following the quarter four earnings report and press release on January 30, 2014, which indicates that the market perceived the report as good news. Google reported earnings and growth across the board of its operations for the fourth quarter of 2014, so it does make sense for the rise in stock price and that the market would perceive the report as good news for the performance of the company.

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

i. Google reported revenues of $16.9 billion in 2013, which was slightly higher than analyst projections of $16.8 billion. This figure reported is in accordance with the positive stock market reaction of the press release, as Google saw 17 percent growth in its advertising operations and outperformed analyst projections. However, Google had smaller net income of $3.38 billion, with an EPS of $9.90 per share. According to Google's Non-GAAP financial figures, its EPS was $12.01, which was smaller than analyst predictions of $12.20. While this figure is lower than projected, it is only slight smaller than projections, and had little effect on the increase in stock price that Google saw in response to its fourth quarter earnings reports. Overall, these reports do reflect the positive reception of the

market following the press release.

ii. Figures that would contribute to the positive reaction of the market would be the overall growth the company experience over the course of the year of 17 percent in its advertising operations. In addition, the overall 60 percent rise in stock price over the course of the year could be a major contributor to the positive market reaction, as investors could be encouraged by the trend of the company's stock prices as a sign of future performance. Furthermore, the increase of the company's capital expenditures from $3.3 billion to $7.4 billion was a 125 percent increase, indication strong growth in the company. Google's cash balance also increased to $58.7 billion and the company also added to its overall employee numbers. Google also sold Motorola to Lenovo, from which it had absorbed $2 billion in losses since its acquisition, representing an opportunity to eliminate such losses. These figures indicate strong growth and are a positive sign for continuous growth, which could be contributors to the positive market reaction. Google's stock was also trading at a value thirty-one times higher than its 2013 earnings. Figures that could be concerning for investors in Google could be the 11 percent decline in click revenue for customers clicking on ads on the website. In addition, in relation to competitors such as Facebook, Google's earnings did not increase at the same rate. Such figures could be concerning for investors, as they potentially show that Google is not increasing its profits at the same rate as other company's in the ad business, such as Facebook. Overall, Google reported strong growth and stock price, which is a good indicator of future for performance and the reason for the positive reactions of investors.

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On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this thesis: