Fundamental Principles of Accounting: A Case Analysis

Benjamin Bradford
University of Mississippi

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Fundamental Principles of Accounting: A Case Analysis

By
Benjamin Chase Bradford

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

Oxford
May 2020

Approved by

Advisor: Dr. Victoria Dickinson

Reader: Dr. W. Mark Wilder
ABSTRACT

Ben Bradford: Fundamental Principles of Accounting: A Case Analysis

(Under the direction of Dr. Victoria Dickinson)

The following thesis examines twelve case studies in financial accounting standards in order to develop a more thorough understanding of public accounting procedures. Each case focuses on a different topic in public accounting, including accounting standards, accounting principles, accounting theory, financial statement preparation, or financial analysis. The case studies included within this thesis demonstrate an understanding of financial standards in accordance with Generally Accepted Accounting Principles (GAAP), financial statement preparation, financial analysis, and current issues in accountancy. These case studies were completed under the direction of Dr. Victoria Dickinson in fulfillment of the requirements of the University of Mississippi, Sally McDonnell Barksdale Honors College.
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Case One: Data Analysis Tools

A comparison of emerging technologies in the accounting field, including Alteryx, Domo, Google Fusion, IBM’s Watson, IDEA, Microsoft Power BI, Python, SAS, Splunk, Tableau, and Apache Hadoop.

Prepared by: Ben Bradford

September 5, 2018
Executive Summary
This exercise introduced me to the value of this course (namely, recognizing issues and applications within the accounting field that otherwise would not be covered in normal coursework). More specifically, the discussion in class introduced me to a diverse array of emerging technologies in the accounting field, including Alteryx, Domo, Google Fusion, IBM’s Watson, IDEA, Microsoft Power BI, Python, SAS, Splunk, Tableau, and the focus of my responses, Apache Hadoop. While the discussion in class was obviously not thorough enough to discuss use and implementation specifics, I feel more secure in my future career knowing the terminology and uses of these tools, which are rapidly entering use both in the Big Four and among numerous smaller firms.

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

Apache Hadoop is an open-source software framework that distributes the processing of large data sets over many computers. Put more simply, Hadoop solves one of the worst problems in accounting: the long wait time while Microsoft Excel loads or processes something. (Apache, 2018) In business applications, this technology is used to efficiently analyze large amounts of data, like transaction information or user behavior, and find trends. This technology is often referred to as “Big Data.” Companies like Amazon, eBay, and Facebook use Hadoop installations for this purpose, optimizing customer recommendations and improving search data. (PowerBy- Hadoop Wiki, 2018) Hadoop’s open source nature makes the cost of implementation lower than competitors, but a staff
knowledgeable in Java and server or cloud processing power and storage are necessary for a proper installation.

B. How, specifically, would you use the tool in the following business settings? Create at least three specific scenarios for each category in which the tool would lead to more efficiency and/or better effectiveness.

i. Auditing

Hadoop presents several opportunities for auditors. For example, Hadoop’s ability to process large amounts of data from a variety of data streams enables it to effectively analyze risk, fine-tuning assessments of bad debts and collection rates for receivables. Where management and accountants previously made what amounted to educated guesses, a Hadoop installation could provide far more accurate information. In a continuous audit environment, Hadoop data analysis could also analyze transaction data in real time, flagging events that look fraudulent immediately. In traditional auditing, fraud is generally only discovered long after the crime has been committed; with Hadoop’s help, fraud could be uncovered in the moment it happens. (Information Age, 2018) Finally, Hadoop’s ability to process large data sets allows it to quickly process millions of events. Where a systems audit of a large retail institution would previously only pull random samples of sales events, Hadoop could audit every single sales event a company’s internal system processed in a given period of time. (Syncsort Trillium Software Blog, 2015)
ii. Tax Planning

Apache Hadoop also presents a few opportunities in the Taxation field of accounting. Hadoop’s ability to process large amounts of unstructured data makes it valuable for creating a centralized repository of financial information. Hadoop can process laws and regulations, emails, PDF files, traditional tax filings, and corporate memos. Hadoop’s ability to collect information also results in more relevant data, reducing risk and uncertainty. Instead of spending billable hours searching various documents for the information needed, tax professional can spend their time on more complex, higher-level questions and issues. (EY, 2016)

Visualization and trend analysis are another advantage afforded by Hadoop installations. Visualization highlights large changes in account balances from year-to-year, potentially uncovering mistakes. Finally, Hadoop enables users to quickly react to changing, complex tax laws, applying alternative treatments to determine the lowest possible client tax exposure. This application reduces the cost of tax compliance by reducing menial workload and allows firms to engage tax professionals on more complex tasks. (Deloitte, 2016)

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

From: Ben Bradford

Date: 8/29/2018

Subject: Benefits of Apache Hadoop Implementation

   It is my opinion that our team’s investment in acquisition and training in this tool would be worthwhile for the advantages afforded in audit services, tax, and advisory services. In Ernst and Young’s 2016 report on Big Data tools in tax services, including Apache Hadoop and competitors, an increase in efficiency of forty percent was reported. If similar increases in efficiency could be recognized in the other two fields, the benefits in labors costs would far exceed implementation costs. (EY, 2016)

   Beyond efficiencies improvements, Hadoop’s ability to process unstructured data and find trends would make our work considerably more accurate. The tax department could respond to changes in tax law far more quickly; audit could detect fraud events immediately; advisory could develop insights on potential acquisitions and partnerships for clients faster than ever before.

   Future engagements would progress more quickly with this tool and staffing needs would be reduced. As Hadoop can quickly process unstructured data, finding information in emails, financial reports, and even PDFs, associates are free to solve complex issues instead of entering data. Staffing levels could be reduced, while teams perform faster and more effectively than ever before.
Case Two: Rocky Mountain Chocolate Factory, Inc.

Preparing Financial Statements
Prepared by: Ben Bradford
September 12, 2018
Executive Summary

This case allowed me to develop a better understanding of financial statement relationship. By manually handling journal entries and closing entries on a series of spreadsheets, the relationship between accounts and how figures “flow” from the balance sheet to the income statement to the statement of cash flows became readily apparent. This case was enlightening because it demonstrated real world problems in accounting- namely, how an auditor would reconstruct the books to properly assertain a company's financial state. While tedious in places, I feel more confident in my knowledge of basic accounting formulas (credits and debits, structure of the balance sheet and income statement) than I did prior to this case study.

This case had the additional benefit of strengthening my Microsoft Excel capabilities, a crucial skill in the world of auditing that is only tangential in accounting education. Seeing how the accounts actually interact on a computerized spreadsheet made me think critically about both Excel formulas and models as well as how accounting entries work in practice.
Case Analysis

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

Rocky Mountain Chocolate Factory, Inc., incorporated in 1982, is an international franchiser, confectionery manufacturer and retail operator in the United States, Canada and the United Arab Emirates. The Company manufactures an extensive line of premium chocolate candies and other confectionery products. The Company's revenues are derived from three principal sources: sales to franchisees and others of chocolates and other confectionery products manufactured by the Company; the collection of initial franchise fees and royalties from franchisees' sales; and sales at Company-owned stores of chocolates and other confectionery products.

As a manufacturer, Rocky Mountain Chocolate Factory's major assets are in cash, inventory, and equipment. Major liabilities include accounts payable and accrued salaries and wages, as the company requires large amounts of labor and materials to convert to finished goods.

B. Based on the transactions recorded, list at least three adjustments or reclassifications that might need to be made prior to preparing the final financial statements.
Several improvements can be made to Rocky Mountain Chocolate Factory's accounts. First of all, Rocky Mountain has interest income listed as an expense account, with a negative debit (credit) balance. The account should instead be listed as a credit normal revenue account.

A second potential improvement is that Rocky Mountain has two asset accounts simply labeled "Other." We can assume that one is used to track short-term, or more liquid assets and the other holds long-term assets, but an improved naming scheme would simplify this for readers of these documents.

Finally, the company does not seem to accumulate depreciation- at least not as shown here. Using an accumulated depreciation contra-asset account would simplify the creation and tracking of schedules of depreciation.
Appendix

Transaction List:

i. The company purchased $7,500,000 of raw material inventory on account. “On account” means that their suppliers have not yet been paid. That is, Rocky Mountain Chocolate has an additional “Account Payable” for the inventory purchase.

ii. During the year, the company incurred $6,000,000 of factory wages. When wages relate to the production of a company’s inventory, the wage costs are added to the inventory account. For now, assume that the wages have not yet been paid.

iii. The company sold inventory that cost $14,000,000 for a total of $22,000,000. Of that, $17,000,000 was received in cash and $5,000,000 was on account (that is, added to accounts receivable).

iv. The company paid $8,200,000 to suppliers for inventory it had previously purchased on account. That is, it paid $8,200,000 of accounts payable.

v. The company collected $4,100,000 of accounts receivable.

vi. The company incurred sales and marketing expenses of $1,505,431, general and administrative expenses of $2,044,569, and retail operating expenses of $1,750,000. They paid $2,000,000 in cash and $3,300,000 was added to other accrued expenses.

vii. The company paid $6,423,789 to employees for wages that had been previously accrued.
viii. Rocky Mountain Chocolate Factory received $125,000 in cash from new franchisees. The company must provide services to the franchisees over the next five years. As such, the fees are considered deferred income.

ix. The company paid $498,832 for new property and equipment.

x. During the year, the company declared $2,407,167 of dividends on its common shares. They paid $2,403,458 during the fiscal year. The difference, $3,709, will be paid in the following fiscal year.
<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$27,262,147</td>
<td>$24,847,000</td>
<td>$25,210,000</td>
<td>$25,000,000</td>
<td>$25,000,000</td>
<td>$25,000,000</td>
<td>$25,000,000</td>
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<td>$25,000,000</td>
<td>$25,000,000</td>
<td>$25,000,000</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>$21,072,147</td>
<td>$19,750,000</td>
<td>$19,810,000</td>
<td>$20,000,000</td>
<td>$20,000,000</td>
<td>$20,000,000</td>
<td>$20,000,000</td>
<td>$20,000,000</td>
<td>$20,000,000</td>
<td>$20,000,000</td>
<td>$20,000,000</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>$6,190,000</td>
<td>$5,097,000</td>
<td>$5,339,000</td>
<td>$5,500,000</td>
<td>$5,500,000</td>
<td>$5,500,000</td>
<td>$5,500,000</td>
<td>$5,500,000</td>
<td>$5,500,000</td>
<td>$5,500,000</td>
<td>$5,500,000</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td>$5,500,000</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Operating Income</td>
<td>$700,000</td>
<td>$797,000</td>
<td>$939,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Interest Income</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Income before Taxes</td>
<td>$700,000</td>
<td>$797,000</td>
<td>$939,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Income Tax Expense</td>
<td>$27,210</td>
<td>$27,210</td>
<td>$27,210</td>
<td>$27,210</td>
<td>$27,210</td>
<td>$27,210</td>
<td>$27,210</td>
<td>$27,210</td>
<td>$27,210</td>
<td>$27,210</td>
<td>$27,210</td>
</tr>
<tr>
<td>Net Income</td>
<td>$672,790</td>
<td>$770,320</td>
<td>$897,000</td>
<td>$972,790</td>
<td>$972,790</td>
<td>$972,790</td>
<td>$972,790</td>
<td>$972,790</td>
<td>$972,790</td>
<td>$972,790</td>
<td>$972,790</td>
</tr>
</tbody>
</table>

### Notes
- Income Tax Expense is calculated based on the company's annual taxable income.
- Interest Income and Expense are calculated based on the company's annual interest earned and paid.
- Operating Expenses include all costs incurred in generating sales, excluding interest and income tax.
- Interest Income is calculated as the interest earned on the company's investments.
- The company's net income is calculated as the difference between revenue and all expenses.
Rocky Mountain Chocolate Factory, Inc.

Balance Sheet

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Assets</strong></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>$3,743,092</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>$4,427,526</td>
</tr>
<tr>
<td>Notes receivable</td>
<td>$91,059</td>
</tr>
<tr>
<td>Inventories</td>
<td>$3,281,447</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>$461,249</td>
</tr>
<tr>
<td>Other</td>
<td>$220,163</td>
</tr>
<tr>
<td><strong>Total current assets</strong></td>
<td>$12,224,536</td>
</tr>
<tr>
<td>Property and Equipment, Net</td>
<td>$5,186,709</td>
</tr>
<tr>
<td><strong>Other assets</strong></td>
<td></td>
</tr>
<tr>
<td>Notes receivable, less current portion</td>
<td>$263,650</td>
</tr>
<tr>
<td>Goodwill, net</td>
<td>$1,046,944</td>
</tr>
<tr>
<td>Intangible assets, net</td>
<td>$110,025</td>
</tr>
<tr>
<td>Other</td>
<td>$88,050</td>
</tr>
<tr>
<td><strong>Total other assets</strong></td>
<td>$1,508,669</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$18,919,914</td>
</tr>
</tbody>
</table>

| 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                             | $0       |
| Series A Junior Participating Preferred Stock| $0       |
| Undesignated series                         | $0       |
| 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 stockholders' equity** | $18,919,914 |

Figure 2.2 Balance Sheet, February 28, 2010
## Rocky Mountain Chocolate Factory, LLC

### Income Statement

For the year ended February 28th, 2010

<table>
<thead>
<tr>
<th>Revenues</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$ 22,944,017</td>
</tr>
<tr>
<td>Franchise and Royalty Fees</td>
<td>$ 5,492,531</td>
</tr>
<tr>
<td><strong>Total Revenues:</strong></td>
<td><strong>$ 28,436,548</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Costs and Expenses</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of sales</td>
<td>$ 15,155,431</td>
</tr>
<tr>
<td>Franchise costs</td>
<td>$ 1,499,477</td>
</tr>
<tr>
<td>Sales and marketing</td>
<td>$ 1,505,431</td>
</tr>
<tr>
<td>General and administrative</td>
<td>$ 2,422,147</td>
</tr>
<tr>
<td>Retail operating</td>
<td>$ 1,756,956</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>$ 698,580</td>
</tr>
<tr>
<td><strong>Total costs and expenses:</strong></td>
<td><strong>$ 23,038,022</strong></td>
</tr>
</tbody>
</table>

| Operating Income          | $ 5,398,526 |
| Interest expense          | $ -         |
| Interest income           | -$27,210    |
| Other Expenses, net       | $ -         |
| Income Before Income Taxes| $ 5,425,736 |
| Income Tax Expense        | $ 2,090,468 |
| **Net Income**            | **$ 3,335,268** |

---

*Figure 2.3- Income Statement, Period Ended February 28, 2009*
Case Three: Class Discussions Regarding Accounting Career Dilemmas

Prepared by: Ben Bradford

September 19, 2018
Executive Summary

This case involved a series of three discussions in class regarding accounting career choices and dilemmas. Each discussion was based on the facts of a conversation between Dr. Dickinson and unnamed accounting students. After listening to the facts of the conversation, the class was then asked to move based on their opinion on the topic. A class discussion then followed each topic or dilemma between the opposing sides, as moderated by Dr. Dickinson.
Case Analysis

A. Discussion One

The first discussion involved the comparative merits of tax law and traditional taxation services in the accounting field. The first speaker said that he intended to take the Law School Admission Test (LSAT), attend law school, and ultimately practice tax law. The second speaker countered that law school could be expensive and would mean three more years of schooling when the student could instead be earning money as a CPA. The first responded that he “Has a cousin that does tax law in New York and makes tons of money.” When asked if he will take an internship, the student says that he plans to do so to better understand the accounting field and improve his resume prior to law school applications.

Personally, I’m inclined to agree with the law school student’s opinion. While work in tax and tax law are similar, the combination of a CPA and a JD makes a graduate more versatile and desirable in the job market. Not only is pay higher for the tax lawyer, but opportunities are much greater – the tax lawyer can pursue public accounting, business, tax law, or any other form of law. The plan to take an accounting internship seems prudent, too: If the student is competitive enough to land a quality internship, it would look good on law school applications. The student will gain a better understanding of accounting, too, and may like the internship experience enough to scrap their law school plans entirely.

B. Discussion Two

The second discussion was similar to the first, with a student indicating that they plan to graduate with an accounting degree from Ole Miss and pursue a job in investment
banking instead of public accounting. Discussion centered on whether the student should instead transfer into the College of Business for a finance degree, and whether the student should take an accounting internship offer if they intend to enter another field of work after graduation.

On the first question, I believe that an accounting degree from a top-ten accounting program nationally distinguishes a graduate enough to make the degree transferable. A business degree from Ole Miss would not have the same impact on potential employers, even if the degree in question is more relevant to banking or finance work. Finance and accounting are similar enough to make the distinction irrelevant. On the other hand, I respectfully disagree with the student about the benefits of an accounting internship. An internship is an opportunity to network and learn about a desired job, and a public accounting internship accomplishes neither for this student. While not easy, I think this student should instead pursue an investment banking internship.

C. Discussion Three

The final class discussion centered on whether an accounting internship or job offer could be transferred. A student contacted Dr. Dickinson asking for advice about moving cities after completing an internship with a firm in a city they do not like. The student interned in Washington D.C., and received a job offer from that office upon completion. The student, though, has decided that they want to move back home to Houston, and work for the same firm’s office in that market. The issue was whether the student should tell the firm about their desire to work elsewhere.
Dr. Dickinson advised the student to take the job offer in D.C., then request a transfer to another office after two or three years of employment, as it was unlikely they would let the student transfer unless they were an especially high performer.

Additionally, the student’s opinion of the office and city could change over the longer period of time. Respectfully, I must disagree. Accounting skills transfer among employers fairly easily, and there would be no shortage of accounting jobs in a market as large as Houston. Even in the firm the student interned with refused to transfer the job offer, student would have plenty of options in the market of their choice.
Case Four: Generic Bank, Inc.

Assessing Securities Impairment

Prepared by: Ben Bradford

October 3, 2018
Executive Summary

This case began with a lengthy statement about the financial position of a fictional bank. The bank in question, Generic Bank, is well-capitalized, but the bank’s securities portfolio is a net loss position. We were asked to determine whether the bank should record relevant securities at fair value (requiring an impairment loss), or continue to carry the securities at historical cost, using the facts of the case with supporting evidence for our decisions from the ASB Codification. The case offered greater insight into how banks and the banking industry functions. Additionally, this case provided evidence that many issues within the accounting field are not discrete but require good judgment and analysis of intent.
Case Analysis

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

Generic Bank should recognize an impairment loss in 20x2 for five of the securities sold in early 20x3- securities 003, 015, 025, 030, and 076. Securities 067 and 096 should not recognized as impairment losses because those holdings are unrealized holding gains, not losses. ASC 320-10-35-25(a) says, “If an entity has estimated the fair value of a cost-method investment (for example, for disclosure under Section 825-10-50), that estimate shall be used to determine if the investment is impaired for the reporting periods in which the entity estimates fair value. If the fair value of the investment is less than its cost, proceed to Step 2.” The five securities listed have seen losses, and the fair value of these investments is lower than their historical cost. Step 2 requires Generic Bank to prove that the impairment loss is other-than-temporary, which it does by indicating intent to sell the securities. This rule is defined in ASC 320-10-35-33, which reads, “When an entity has decided to sell an impaired available-for-sale security and the entity does not expect the fair value of the security to fully recover before the expected time of sale, the security shall be deemed other-than-temporarily impaired in the period in which the decision to sell is made, not in the period in which the sale occurs.” This policy establishes that impairment is only recognized when a company intends to sell relevant impaired investments. Moreover, this explains why the company should recognize the impairment
in 20X2, not 20X3. Even though the securities are sold in early 20X3, the securities become impaired “in the period in which the decision to sell is made.”

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

Generic Bank would not be required to report an impairment loss on securities other than the seven securities sold. Generic Bank makes it clear that the purpose in selling these particular securities is to derive working capital for employee bonuses and strategic acquisitions; they do not need to sell the securities to maintain working ratios. ASC 320-10-35-33 lists a variety of conditions under which an investor has an impairment loss: these conditions include intent to sell, likelihood the entity will be required to sell the securities before they mature, and whether the entity expects to recover the amortized cost basis. Generic Bank’s position in other securities satisfies none of these characteristics. The Bank does not intend to sell these securities, and bank management intends to hold the other securities until they mature, believing that relevant declines in value of debt securities “relate primarily to changes in interest rates and not credit deterioration.” Therefore, the bank does not need to report an impairment, and can continue to carry the debt securities on an amortized historical cost basis.
C. Does your answer change if you assume the role of Heather Herring, the external auditor? Does your answer change if you assume the role of a bank regulator? What other factors might an external auditor or regulator consider in making their determination?

The treatment above would be consistent if the role of an external auditor or bank regulator was assumed, although greater scrutiny would be required for the bank’s assertions. The positions described above are based on assumptions about the factuality of Generic Bank’s comments regarding capitalization and management’s intent. If the bank was less well capitalized and needed to raise cash to meet capital requirements, their assertions that the sale of debt securities was strictly for employee bonuses and strategic acquisitions would be called into question. 320-10-35-33b requires entities to recognize an impairment loss when management believes they may be required to sell a debt security before that security matures, so a substantial portion of Generic Bank’s investments would be reported at fair value, requiring impairment losses. Generic Bank’s assertion that the decline in fair value was only the temporary result of changes in interest rates would also be challenged by an auditor or bank regulator. If the bank was dishonest about their expectation that the value of all the securities would recover, they would be required to report an impairment loss for any securities they believed would not recover. This policy is described in 320-10-35-33C: “If an entity does not expect to recover the entire amortized cost basis of the security, the entity would be unable to assert that it will recover its amortized cost basis even if it does not intend to sell the security. Therefore, in
those situations, an other-than-temporary impairment shall be considered to have occurred.”

D. 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?

ASC 320-10-35-25(a) states, “If an entity has estimated the fair value of a cost-method investment (for example, for disclosure under Section 825-10-50), that estimate shall be used to determine if the investment is impaired for the reporting periods in which the entity estimates fair value. If the fair value of the investment is less than its cost, proceed to Step 2.” If fair value of an investment is greater than its cost, the company would not report an impairment. Impairment should only be recognized for investments in a loss position. If all securities sold were in a gain position, no impairment at all would be recognized.

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

If Generic Bank was merely adequately capitalized instead of well capitalized, the chance that an impairment loss should recorded on debt securities that have declined in value is greater. As described in ASC 320-10-35-33, Generic Bank does not have to report an
impairment on securities if it intends to hold those securities until they mature, it’s unlikely they will be required to sell the securities prior to maturity to meet other obligations, and the bank believes the investments have not permanently declined in value below their amortized cost. In a situation where the bank was less well-capitalized, however, and has limited access to other forms of borrowing, the second condition of ASC 320-10-35-33 would be called into question. That section of the codification says, “If the entity more likely than not will be required to sell the security before recovery of its amortized cost basis, an other-than-temporary impairment shall be considered to have occurred.” This rule would require the bank to define the securities as other-than-temporarily impaired, and an impairment loss would need to be reported on other securities.
Case Five: Career Location Considerations

Prepared by: Ben Bradford

November 7, 2018
Executive Summary

In this case, we were challenged with researching what life would be like in two potential locations to start a career. Topics researched included such practical considerations as taxes, crime, and cost of living, as well as more subjective elements, like climate favorability, available amenities, and geographic location.

In the class discussion following this case, Dr. Dickinson emphasized the importance of this step of the accounting recruitment process. Firms expect students to apply for internships in locations in which they intend to work for several years. Internships turn into job offers, and job offers turn into careers. Thus, it is important at this time to consider the practical components of life in a given city, which is what follows in this case. The following case examines a series of livability factors, quantitative and qualitative, in an attempt to gain a better understanding of what life would be like in a series of prospective locales.
Case Analysis

Location One: Birmingham, Alabama

a) What is the population?

At the most recent count (2017), Birmingham, Alabama had a population of 210,710, with a metro area of 1,149,807 people. Birmingham is the most populous city in Alabama.

b) Describe the climate and seasonal fluctuations.

As a city in the deep South, Birmingham features a hot, humid climate with mild winters. Snow is uncommon but has been known to occur intermittently.

c) Describe the city’s topography, scenery, and other geographical/geological features of the area in which the city is located.

Birmingham’s geography is characterized by several large hills and valleys, which are used to denote various areas of the city. The largest of these hills are considered part of the Appalachian Mountain range, including Red Mountain and Shades Mountain.

d) What are the individual tax rates within the city?

Birmingham has a relatively high sales tax, at ten percent. If I purchased property, I would be subject to property taxes according to property assessment and millage rates, but these factors would not apply to me as a renter. Alabama also has a state income tax of 2 percent on the first $500 of taxable income, 4 percent on income from $500 to $3,000, and 5 percent on all taxable income over $3,000. Based on this information, and
assuming I make $50,000 per year, I would pay $2,460 in state income taxes above my federal tax exposure, which I estimate at $10,832.

e) What transportation hubs are in the city?

Birmingham is home to Birmingham-Shuttlesworth International Airport, which offers flights to more than 30 cities. Birmingham also has an Amtrak station, with daily service north to Chicago and south to New Orleans.

f) What is the city’s most prevalent industries?

Historically, Birmingham’s largest industry was steel production. Over the past few decades, the domestic steel industry has declined, but Birmingham is still home to several large steel product manufacturing companies. Today, steel maintains a large presence, but the city has also diversified into several other markets. The presence of a top regional medical school has attracted significant investments in medical research to the city. Banking is another major industry in the city; Regions Bank and BBVA Compass are both headquartered downtown. Finally, construction and construction materials companies comprise a sizable (and growing) part of the local economy.

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

Birmingham is considered a regional hub for medical services and is served by over six regional hospitals. The presence of the University of Alabama at Birmingham’s (UAB) medical school and research hospitals, along with the substantial healthcare industry in the city, make Birmingham’s healthcare quality above average.
h) What types of crime are common within the city and where are the locations within the city to avoid?

Unfortunately, Birmingham is among the most violent cities in America, in terms of both total crime and violent crime, though Birmingham’s crime rate is not out of line with other Southern cities (Atlanta, Jacksonville, and Charlotte also rank highly on this metric). Generally speaking, the suburbs to the southeast of downtown (Homewood, Vestavia Hills, Hoover, and Mountain Brook) are considered safe, while the suburbs north and west of the downtown hub (Druid Hills, Fountain Heights, Titusville, Glen Iris) are considered more dangerous.

i) Based on where you see yourself living for the first three years, how much rent do you expect to pay?

Rent is comparatively cheap in Birmingham, and I would probably rent a house in one of the more desirable suburbs listed above. The consensus for housing options in this area seems to be $1000-$1500 per month. Here are a few examples:

Property One:

- 2 bedrooms, 2 bathrooms
- 1600 square feet
- $1075/month or $537.50 per person

Property Two:

- 2 bedrooms, 2.5 bathrooms
- 1900 square feet
- $1500/month or $750 per person
Property Three:

2 bedrooms, 2 bathrooms
1750 square feet
$1095/month or $547.50 per person

All three feature free parking, either on the street outside or in a driveway

j) **What is the typical mode of commuting? What are your likely commute times?**

Commuting is most commonly done by car in Birmingham. Commute times are generally short, and the suburbs described above are close to downtown, resulting in a travel time of 15-25 minutes. During the afternoon rush hour, this time can be delayed, but as a rule, traffic is generally better in Birmingham than larger southern metro areas.

k) **Where will you do your grocery shopping?**

I would do my grocery shopping at the nearest grocery store or supermarket. I would arrive there by driving.

l) **How will you do your laundry?**

I would do my laundry in the laundry room at the house I would rent. All of the above housing options include laundry rooms with a washer and dryer, and this is typical for the housing rental market in Birmingham.

m) **Name at least three civic, religious, or charitable organizations you would like to be active in for each city.**
If I was living in Birmingham, three charities I would choose to be active in Episcopal Place, a religious organization that houses the homeless, Hand in Paw, which connects dog owners with children in need of pet therapy, and Better Basics, a group that promotes childhood literacy.

n) **What are the sports, entertainment, or recreational activities that you would be most likely to engage in within the city?**

There are several activities I would be likely to engage in during my time in Birmingham not dedicated to accounting. Watching live sports would be one example. Birmingham is home to a minor league baseball team, the Birmingham Barons, and a decent college basketball team at UAB. Another potential activity would be engaging in the culinary scene. Birmingham is known regionally for some of the best examples of Southern cuisine, and an entire chapter of John T. Edge’s book on Southern food is dedicated to Birmingham. A third activity would be watching live music. Birmingham has regular concerts and two summer music festivals. A fourth activity would be running. Birmingham has several nice parks, and the suburbs of Mountain Brook and Vestavia Hills are both serviced widely by abundant running trails. Finally, I would enjoy visiting museums, like the Sloss Furnaces National Historic Landmark and the Barber Vintage Motorsports Museum.

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

The most obvious mode of travel back to my hometown would be by car, as there is no direct flight from Panama City to Birmingham. The drive is less than five hours; google
says the distance is 266 miles. At 30 miles per gallon, and gas prices of $2.40 a gallon, such a trip would only cost $21.28 each way.
Location Two: Atlanta, Georgia

1. **What is the population?**

   The population of Atlanta is 486,290, with a metro area population totaling 5.8 million people.

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

   Atlanta features a hot, humid climate, with hot summers and mild winters. Snow is uncommon, but freezing weather tends to cause issues to the city’s transportation networks during the winter.

3. **Describe the city’s topography, scenery, and other geographical/geological features of the area in which the city is located.**

   Atlanta is located in the foothills of the Appalachian Mountains, with the official start of the Appalachian Trail just an hour north of the city. Atlanta is located near Lake Lanier, a lake and recreational area, and at the start of the Chattahoochee River.

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

   Atlanta has a relatively high sales tax, at 8.9 percent. If I purchased property, I would be subject to property taxes according to property assessment and millage rates, but these factors would not apply to me as a renter. Georgia also has a state income tax of 2 percent on the first $750 of taxable income, 3 percent on income from $750 to $2,250, 4 percent on income up to $3,750, 5 percent on income up to $5,250, and 6 percent on all taxable income over $7,000. Based on this information, and assuming I make $50,000 per year, I
would pay $2,510 in state income taxes above my federal tax exposure, which I estimate at $10,832.

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

Atlanta is characterized by its spread of interstate highways, and automobile travel is the predominant means for travel throughout the city and suburbs. The city runs a public transportation system downtown of buses and heavy rail known as MARTA (Metro Atlanta Rapid Transit Authority). This system connects key hubs but fails to reach outlying suburbs. Atlanta is also home to Hartsfield-Jackson International Airport, the busiest airport in the world.

6. **What is the city’s most prevalent industries?**

Atlanta’s economy is among the twenty largest in the world. The city hosts the global headquarters of Coca-Cola, Home Depot, Delta Air Lines, AT&T, Chick-fil-a, CNN, and UPS. In recent years, Atlanta’s technology sector has grown, and entertainment represents another growing field in the region.

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

Statistically, Georgia ranks poorly on healthcare metrics when compared to other states. Atlanta is served by several hospitals, as a large metropolitan area, but quality of care is likely worse than other similarly sized American metros.
8. **What types of crime are common within the city and where are the locations within the city to avoid?**

Atlanta has a reputation as a violent city, and the crime rate and violent crime rate are both considerably higher than the national average. As a general rule, the urban communities south of downtown have a reputation for high crime, while the suburbs to the north of the city are generally safer.

9. **Based on where you see yourself living for the first three years, how much rent do you expect to pay?**

If I were to live in Atlanta, I would probably opt for an apartment in a desirable suburb like Decatur or Buckhead. Here are three examples of housing opportunities in those areas:

Property One (Decatur):

- 1 bedrooms, 1 bathroom
- 811 square feet
- $1498/month

Property Two (Buckhead):

- 2 bedrooms, 2 bathrooms
- 1400 square feet
- $2100/month or $1150 per person

Property Three (Decatur):

- 1 bedrooms, 1.5 bathrooms
- 1500 square feet
$1250/month

All three of these options are located within walking distance of desirable downtown districts, and include covered, secure parking and laundry in-suite.

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

Despite the existence of MARTA’s public transportation system, I would probably commute by car. Atlanta has a reputation for lengthy commute times and heavy traffic. I estimate that my daily commute would be upwards of thirty or forty-five minutes from the suburbs to downtown, with travel to client sight taking over an hour.

11. **Where will you do your grocery shopping?**

I would do my grocery shopping at a nearby supermarket, which I would reach by car.

12. **How will you do your laundry?**

All the housing options listed above feature a washer and dryer, and I believe this represents the norm in the Atlanta rental property market.

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

Three charities I would get involved with, if I were to live in Atlanta, would be the Alliance for International Reforestation, which provides environmental education to low-income families in Central America, the Live Healthy and Thrive Youth Foundation, which promotes physical wellness and fitness for children, and Project GRAD Atlanta,
which works to increase the high school graduation rate and college attendance at low-income schools.

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

There are several activities I would be likely to engage in while working in Atlanta. First, I would likely take advantage of Atlanta’s live sports opportunities. Atlanta is home to a professional baseball team (Braves), football team (Falcons), basketball team (Hawks), and soccer team (Atlanta United). Atlanta also hosts professional golf events and multiple college football games each year. Another activity I would be likely to engage in would be watching live music. As a top-ten metro area by population, Atlanta is a stop on essentially every national tour for major artists, and the city hosts several music festivals throughout the year. I would also be likely to do some hiking. Just north of Atlanta is the start of the Appalachian Trail, and hiking opportunities within short driving distance are abundant. Atlanta also features a dynamic culinary scene, with a wide variety of international foods. I would be likely to explore the thousands of unique restaurants in the city if I were to live in Atlanta. Finally, Atlanta is home to many different, interesting museums, including Jimmy Carter’s presidential library and the college football hall of fame.

15. What are the modes of traveling back to your hometown from this city? What is the average cost you’d incur for each trip back home?
Travel from Atlanta to my hometown could be accomplished via a direct flight or by driving. I would probably be inclined to use the section option based purely on lower costs. The drive takes about five hours, and google lists the distance as 289 miles. Assuming my efficiency is 30 miles per gallon, and gas costs $2.40 per gallon, such a trip would cost $23.12, each direction.
Final Considerations:

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

<table>
<thead>
<tr>
<th></th>
<th>Birmingham</th>
<th>Atlanta</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent</td>
<td>14400</td>
<td>18000</td>
</tr>
<tr>
<td>Utilities</td>
<td>4200</td>
<td>4200</td>
</tr>
<tr>
<td>Food</td>
<td>9180</td>
<td>9180</td>
</tr>
<tr>
<td>Gas/Auto</td>
<td>2080</td>
<td>2080</td>
</tr>
<tr>
<td>Discretionary</td>
<td>1848</td>
<td>1198</td>
</tr>
<tr>
<td>Taxes</td>
<td>13292</td>
<td>13342</td>
</tr>
<tr>
<td>Savings</td>
<td>5000</td>
<td>2000</td>
</tr>
</tbody>
</table>

Figure 5.1- Comparative City Budget

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

Based on my full analysis, I would still enjoy living and working in either city. I like Birmingham’s smaller size, but Atlanta is a much bigger market, which I think would create more career opportunities (and more interesting work). For that reason, I think I would choose Atlanta.
Case Six: MCI Worldcom Inc.

A Study in Fraudulent Capitalization

Prepared by: Ben Bradford

November 16, 2018
Executive Summary

This case focused on the financial fraud that resulted in WorldCom’s prominent collapse in the early 2000s. The company improperly capitalized routine expenses in an attempt to make the company appear more profitable than it actually was in 2001. Topics covered in this case included fraud, the definitions of basic accounting concepts, and the ethical issues that accountants can face.
Case Analysis

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

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

      Assets are elements that provide probable future revenue or financial benefits to a company. Expenses are outflows or liabilities incurred in the normal course of business.

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

      In general, costs are expensed as they are incurred. Costs are capitalized as part of an asset when those costs increase the value of the asset or increase probable future cash flows from that asset.

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

      Under capitalization, costs become part of the carrying value of an asset. On the balance sheet, capitalization increases the value of assets and stockholder’s equity. On the income statement, capitalization reduces period expenses, thereby increasing net income. A company that capitalized costs would display higher net income and more assets than an identical company that expensed the same costs.
C. Refer to WorldCom’s statement of operations. What did the company report as line costs for the year ended December 31, 2001? Prepare the journal entry to record these transactions for the year. Explain in your own words, what these “line costs” are.

<table>
<thead>
<tr>
<th>Line Costs</th>
<th>14,739,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>14,739,000,000</td>
</tr>
</tbody>
</table>

WorldCom was a long-distance telecommunications company. “Line Costs” were fees paid to smaller phone companies for use of their networks.

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

WorldCom paid other telecommunication companies to complete their long-distance phone calls in areas where WorldCom did not have their own network infrastructure. These fees were incurred in the course of business in a given period, so they should have been recognized as expenses. WorldCom’s executives chose instead to capitalize the fees as assets, changing a net loss position in 2001 into a net gain.
E. Prepare a single journal entry to record the improperly capitalized line costs of $3.055 billion for the year. Where did these costs appear on the balance sheet? Where on the statement of cash flows? (Journal entries in billions)

<table>
<thead>
<tr>
<th>Line Costs (Expense)</th>
<th>3.055</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, Plant, Equipment</td>
<td>3.055</td>
</tr>
</tbody>
</table>

These costs were initially recorded on the balance sheet as part of Property, Plant, and Equipment assets. These costs were recorded as depreciation and amortization on the statement of cash flows. Capital expenditures are also overstated on the statement of cash flows, to make cash flows appear accurate.

F. In a sworn statement to the Securities and Exchange Commission, WorldCom revealed details of the improperly capitalized amounts (in millions) in 2001: $771 in the first quarter, $610 in the second quarter, $743 in the third quarter, and $931 in the fourth quarter. Assume that WorldCom planned to depreciate these capitalized costs over the midpoint of the range for transmission equipment as disclosed in note 1. Further assume that depreciation begins in the quarter that assets are acquired (or costs capitalized). Calculate the related depreciation expense for 2001. Prepare the journal entry to record this depreciation. (Journal entries in millions)
Calculations to Estimate Depreciation Expense:

Quarter 1: $771,000,000 / 22 years x (4/4 quarters) = $35,045,454
Quarter 2: $610,000,000 / 22 years x (3/4 quarters) = $20,795,454
Quarter 3: $743,000,000 / 22 years x (2/4 quarters) = $16,886,363
Quarter 4: $931,000,000 / 22 years x (1/4 quarters) = $10,579,546

Total Depreciation of Capitalized Items for Year: $83,306,817

Depreciation Expense 83,306,817
Accumulated Depreciation 83,306,817
G. Use your answers to parts e and f above, to determine what WorldCom’s net income would have been in 2001 had line-costs not been improperly capitalized. Use 35 percent as an approximation of WorldCom’s 2001 marginal income tax rate, in your calculations. State any other assumptions you make. Is the difference in net income material?

Calculation of Correct Net Income, 2001

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reported Income, Pre-Tax</td>
<td>2,393,000,000</td>
</tr>
<tr>
<td>Add: Improper Depreciation</td>
<td>83,306,817</td>
</tr>
<tr>
<td>Less: Improper Line Costs</td>
<td>3,055,000,000</td>
</tr>
<tr>
<td>Adjusted Net Income, Pre-Tax</td>
<td>(578,693,183)</td>
</tr>
<tr>
<td>Income Tax Benefit</td>
<td>202,542,614</td>
</tr>
<tr>
<td>Minority Interest</td>
<td>35,000,000</td>
</tr>
<tr>
<td>Adjusted Net Income</td>
<td>$(341,150,569)</td>
</tr>
</tbody>
</table>

The difference between reported net income and actual net income is absolutely material, turning a $2.39 billion gain position into a $341 million annual loss.
Case Seven- Starbucks Corporation

Understanding Financial Statements

Prepared by: Ben Bradford

February 27, 2019
Executive Summary

In this case, I examined the financial statements of Starbucks Corporation, a major international chain of coffee shops based in Seattle, Washington. The case primarily focuses on two elements: comparative financial statements and the additional notes typical to a publicly traded company’s 10-K filing with the Securities and Exchange Commission.

The analysis of comparative financial statements is a crucial part of the auditor’s role, showing how the company’s performance metrics have changed over time, or showing areas of potential fraud (as depicted by a sudden change in an account’s valuation). The additional notes included in a 10-K, including an overview of accounting principles and Management’s guidance, showed the role of the law in the realm of audited financial documents.
Case Analysis

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

Starbucks is an international chain of coffee shops. Their primary business is in food and drinks at the company’s physical locations, though they have subsidiaries that produce prepared food and coffee products for external distribution in convenience stores, supermarkets, and other settings.

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

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

Starbucks’ financial statements for external reporting purposes include a statement of earnings, statement of comprehensive income, balance sheet, statement of cash flows, and statement of equity. Each of these financial statements is described as “consolidated,” meaning that the statements encompass all transactions and events for all of Starbucks’ divisions, subsidiaries, and joint ventures (to the extent of the company’s ownership in such ventures and subsidiaries).

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

Publicly traded companies typically prepare financial statements for external reporting purposes on a quarterly basis.
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.

According to the Securities and Exchange Commission (SEC), company management is responsible for preparing a company’s financial statements. Publicly traded companies like Starbucks are required to hire an independent auditor to verify the truthfulness of management’s assertions in their financial statements. Potential users of Starbucks’ financial statements would primarily be investors and creditors, though management may use the numbers for their own planning purposes and suppliers could also use the information to verify the company’s financial health.

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

Starbucks’ external auditor in 2013 was Deloitte. Deloitte wrote two letters which are included in the company’s financial statements, both dated Novembers 18th, 2013. The letters are dated after the company’s year-end by several months because of the length of time required to conduct the audit. The first letter indicates that Deloitte believes that Starbucks’ financial statements are free from error and conform to Generally Accepted Accounting Principle (GAAP) standards. The second letter reports that Deloitte believes the company maintained adequate internal controls over financial reporting.

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 Statements of Earnings, FY 2012-13

<table>
<thead>
<tr>
<th>Consolidated Statements of Earnings (USD $)</th>
<th>12 Months Ended</th>
</tr>
</thead>
<tbody>
<tr>
<td>In Millions, except Per Share data, unless otherwise specified</td>
<td>Sep. 29, 2013</td>
</tr>
<tr>
<td><strong>Net revenues:</strong></td>
<td></td>
</tr>
<tr>
<td>Company-operated stores</td>
<td>79%</td>
</tr>
<tr>
<td>Licensed stores</td>
<td>9%</td>
</tr>
<tr>
<td>CPG, foodservice and other</td>
<td>12%</td>
</tr>
<tr>
<td>Total net revenues</td>
<td>100%</td>
</tr>
<tr>
<td>Cost of sales including occupancy costs</td>
<td>43%</td>
</tr>
<tr>
<td>Store operating expenses</td>
<td>29%</td>
</tr>
<tr>
<td>Other operating expenses</td>
<td>3%</td>
</tr>
<tr>
<td>Depreciation and amortization expenses</td>
<td>4%</td>
</tr>
<tr>
<td>General and administrative expenses</td>
<td>6%</td>
</tr>
<tr>
<td>Litigation charge</td>
<td>19%</td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>104%</td>
</tr>
<tr>
<td>Gain on sale of properties</td>
<td>0%</td>
</tr>
<tr>
<td>Income from equity investees</td>
<td>2%</td>
</tr>
<tr>
<td>Operating income</td>
<td>-2%</td>
</tr>
<tr>
<td>Interest income and other, net</td>
<td>1%</td>
</tr>
<tr>
<td>Interest expense</td>
<td>0%</td>
</tr>
<tr>
<td>Earnings before income taxes</td>
<td>-229.9</td>
</tr>
<tr>
<td>Income taxes</td>
<td>-2%</td>
</tr>
<tr>
<td>Net earnings including noncontrolling interests</td>
<td>8.8</td>
</tr>
</tbody>
</table>
Net earnings attributable to noncontrolling interest 0.5 0.9
Net earnings attributable to Starbucks $8.30 $1,383.80
Earnings per share - basic $0.01 $1.83
Earnings per share - diluted $0.01 $1.79

**Weighted average shares outstanding:**
- Basic 749.3 754.4
- Diluted 762.3 773
- Cash dividends declared per share $0.89 $0.72

Figure 7.2 Starbucks Consolidated Balance Sheet, 2012 and 2013

### Consolidated Balance Sheets (USD $)

#### In Millions, unless otherwise specified

#### Current assets:

- Cash and cash equivalents 22% $2,575.70 14% $1,188.60
- Short-term investments 6% 658.1 10% 848.4
- Accounts receivable, net 5% 561.4 6% 485.9
- Inventories 10% 1,111.20 15% 1,241.50
- Prepaid expenses and other current assets 2% 287.7 2% 196.5
- Deferred income taxes, net 2% 277.3 3% 238.7
- Total current assets 48% 5,471.40 51% 4,199.60
- Long-term investments 1% 58.3 1% 116
- Equity and cost investments 4% 496.5 6% 459.9
- Property, plant and equipment, net 28% 3,200.50 32% 2,658.90
- Deferred income taxes, net 8% 967 1% 97.3
- Other assets 2% 185.3 2% 144.7
- Other intangible assets 2% 274.8 2% 143.7
- Goodwill 7% 862.9 5% 399.1
- TOTAL ASSETS 100% 11,516.70 100% 8,219.20

#### Current liabilities:

- Accounts payable 4% 491.7 5% 398.1
- Accrued litigation charge 24% 2,784.10 0% 0
- Accrued liabilities 11% 1,269.30 14% 1,133.80
- Insurance reserves 2% 178.5 2% 167.7
- Deferred revenue 6% 653.7 6% 510.2
- Total current liabilities 47% 5,377.30 27% 2,209.80
- Long-term debt 11% 1,299.40 7% 549.6
- Other long-term liabilities 3% 357.7 4% 345.3
- Total liabilities 61% 7,034.40 38% 3,104.70

#### Shareholders' equity:
Common stock ($0.001 par value) - 0%
authorized, 1,200.0 shares; issued and outstanding, 753.2 and 749.3 shares (includes 3.4 common stock units), respectively 0.8 0% 0.7
Additional paid-in capital 2% 282.1 0% 39.4
Retained earnings 36% 4,130.30 61% 5,046.20
Accumulated other comprehensive income 1% 67 0% 22.7
Total shareholders' equity 39% 4,480.20 62% 5,109
Noncontrolling interests 0% 2.1 0% 5.5
Total equity 39% 4,482.30 62% 5,114.50
TOTAL LIABILITIES AND EQUITY 100% $11,516.70 100% $8,219.20

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

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

Starbucks’ major assets are cash, inventory, and property, plant and equipment. 48 percent of Starbucks’ assets are current, while 52 percent are long-term assets. This distribution seems appropriate for a company engaged in the food business.

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

Intangible assets include trademarks, customer lists, copyrights, and franchise rights. Goodwill represents, most directly, the difference
between purchase price of another business and the total value of that company’s assets. Starbucks’ largest intangible asset is likely the trademark on their name and logo, but recipes for specific products are probably also highly valued.

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

Starbucks appears to be financed, to a large degree, from the company’s own retained earnings. About 20 percent of financing comes from non-owner sources, shown in long-term debt, with the remainder coming from retained earnings.

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

i. Review the revenue recognition policies of Starbucks discussed in Note 1 (Summary of Significant Accounting Policies). Does Starbucks record revenue when they receive cash from their customers (cash-basis accounting) or do they follow a different rubric (for example, accrual accounting)? How does Starbucks record revenue on stored value cards (i.e., gift cards)? What challenges in measuring revenue do you observe? That is, are there any significant judgments management needs to make in recording sales revenues at Starbucks?
Starbucks uses both cash and accrual basis accounting. At retail locations, the cash basis is followed; the company says that revenue is recognized when payment is tendered. For the company’s manufactured goods, the accrual basis is followed, and revenue is recognized when the goods are delivered to distributors. Starbucks records revenue from gift cards when those gift cards are used in a store transaction, though revenue is recognized when the company considers the chance of renewal remote (the time period or conditions under which this occurs are not disclosed here).

ii. What are Starbucks’ major expenses?
Starbucks’ major expenses were cost of sales, at 43 percent, and store operating expenses, at 29 percent.

iii. Were there any significant changes in the cost structure during the most recent year?
For 2013, Starbucks added a substantial litigation charge of $2.7 billion, representing almost 20 percent of annual revenues.

iv. In fiscal 2013, Starbucks separately reported a litigation charge and included it in operating income. Why didn’t the company just include this amount within the line item for general and administrative expenses? Why is it an operating expense?
The decision to separate the litigation charge out from general and administrative expenses appears to be a choice to increase transparency. Creating an additional line item also helps management because the name “litigation charge” would suggest that the item is not recurring, while “general and administrative expenses” are a recurring item in every period.

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

Starbucks was profitable during 2012, recording net earnings of $1.4 billion. In 2013, Starbucks reported a loss of $325 from operating income, but due to favorable tax treatment, the company turned a modest profit of $8 million. The profit margin in 2012 was close to 10 percent, while the company’s profits in 2013 amount to a rounding error.

I. **Refer to Starbucks’ fiscal 2013 statement of cash flows.**

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

   Starbucks’ net earnings in FY 2013 were $8 million, as compared to $2.9 billion in net cash provided by operating activities. Most of the difference between these two figures can be attributed to the litigation charge in FY 2013.

   ii. **How much cash did Starbucks use for expenditures for property, plant and equipment during fiscal 2013?**
Starbucks used $1.15 billion to purchase property, plant and equipment in fiscal 2013.

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

Starbucks paid $629 million in dividends in fiscal 2013. Starbucks declared $669 million in dividends.

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?

Asset and goodwill impairments, stock-based compensation forfeiture rates, future asset retirement obligations, inventory reserves, assumptions underlying self-insurance reserves, and income from unredeemed stored value cards are all accounts for which Starbucks makes use of estimates. Cash and cash equivalents and prepaid expenses are likely the only accounts that are entirely estimate-free.
Case Eight- British Petroleum

The Deepwater Horizons Oil Spill and Contingencies Accounting

Prepared by: Ben Bradford

April 3, 2019
Executive Summary

This case focuses on the accounting effects of the 2010 Deepwater Horizon oil spill for oil company British Petroleum (BP). In April 2010, a component on the Deepwater Horizon offshore oil rig failed, resulting in a spill of an estimated 200 million gallons of oil into the Gulf of Mexico.

After the spill, BP took responsibility for cleanup, environmental restoration, and economic restitution for governments, businesses, and private citizens impacted by the spill. Naturally, the economic values associated with an issue of this magnitude are difficult to quantify. This case explores the financial and accounting elements associated with BP’s response to the Deepwater Horizon crisis. Accounting concepts covered include use of contingent liability, use of estimates, warranty costs, and legal liability. From this case, I learned more about how contingent liabilities are handled on financial statements- where they are included, what information may be disclosed by the corporation in the footnotes, and how estimates are reached for potential liability amounts.
Case Analysis

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 a company may incur in the future—though the exact outcome of future events is unknown, the company reasonably believes that they may have future financial obligations as a result of such events. A common example is pending litigation, if the company believes there is a good chance they may be responsible for damages. Other examples include warranty liability and, as in this case, environmental disaster cleanup liabilities. Companies do not record contingent assets or contingent gains, regardless of likelihood of realization, but instead recognize those gains and assets when they are actually realized.

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

From BP’s perspective, as the purchaser, the two-year product warranty on the telescopic joint is either a component of the product’s cost or a prepaid expense, depending on the nature of the original purchase. If GE’s warranty is included in the purchase price of the equipment.
component (assurance-type warranty), then the value of the warranty is capitalized as part of the asset’s cost. If the warranty is an additional, separate cost from the component, then the warranty’s value is reported as a prepaid expense and amortized over the life of the warranty. From GE’s perspective, the warranty’s potential costs represent a contingent liability, and the only difference in these two treatments is when revenue is recognized- the assurance warranty revenue is recognized at time of sale, while the additional warranty revenue is recognized over the two-year life of the warranty.

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

When accounting for contingent liabilities and accrued warranty costs, management must use good judgment to determine appropriate estimates of future capital obligations. In the case of the Deepwater Horizon oil spill, the difference in a claim for damages and a warranty claim on the telescopic joint is enormous- a claim for damages includes all of the aftermath of the oil spill, while a warranty claim only covers defects in the equipment, not the results of the equipment defects. A warranty claim on a piece of equipment like a telescopic joint is readily estimable; BP knows how much they paid for the equipment. A claim for damages resulting from an oil spill, on the other hand, is highly subjective.
i. Describe some of the estimates that BP must make to account for the contingencies associated with the Deepwater Horizon oil spill. By way of comparison, the Exxon Valdez oil spill took place on March 24, 1989. 

Litigation continues as of early 2011.

BP’s accounting for contingencies around the Deepwater Horizon oil spill included estimates for the total costs of environment cleanup efforts, studies on the impact of the oil spill on marine life, litigation, claims paid to impacted businesses and individuals, staffing at claims centers, and grants to states, counties, and local governments. These estimates were based on the amount of oil released, but even BP notes in their financial statement section on contingent liabilities that “the magnitude and timing of possible obligations in relation to the Gulf of Mexico oil spill are subject to a very high degree of uncertainty.”

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

BP had nearly unlimited liability as a result of the Deepwater Horizon oil spill, and the list of potential plaintiffs for lawsuits included five states on the Gulf Coast, countless cities and municipalities, and, through class-action lawsuits, millions of people. The effect of the oil spill went beyond actual damage from the oil- several businesses in my hometown sued for loss-of-income when economic activity during the summer declined because people thought the beaches were contaminated. Other parties beyond BP further complicate matters. BP was the
operator leasing the rig, but the rig is owned by another company, Transocean, and Halliburton was involved in operation. Should they share in liability for damages?

BP drew a boundary around the potential losses by working with the federal government to establish a $20 billion escrow fund for oil spill-related damages. Although this fund did not fully limit BP’s liability, creating the fund for the purposes of all oil-spill related damages did draw a boundary around losses to some degree. Those impacted by the oil spill could operate within BP’s established damages framework, releasing BP from further liability, or they could sue for damages in the legal system and risk years of expensive litigation. Most chose the former option.
Case Nine: The Wendy’s Company and Subsidiaries

Accounting for Joint Ventures

Prepared by: Ben Bradford

April 10, 2019
Executive Summary

This case centered on accounting for subsidiary organizations, using the example of a joint venture between Tim Horton’s and Wendy’s called “TimWen.” Wendy’s is an international fast food restaurant chain best known that was founded in 1969. Wendy’s is known for their distinctive square hamburger patties; the chain has over 6,700 locations worldwide, with the majority of those locations in the United States. Tim Horton’s is a Canadian fast food chain known for coffee and breakfast foods. Together, the two operated a joint venture referred to in the 2012 Wendy’s financial statements as “TimWen.”

Issues covered in the case include the equity method of accounting for investments, fair value adjustments, recording goodwill, and other issues specific to investment in other companies. From this case, I learned more about how investments in other companies are handled on financial statements, which information is relevant in these cases, and where to find this information. It was interesting seeing a real life example after learning the rules of accounting for subsidiaries in a purely sanitized classroom setting.
Case Analysis

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

Companies enter into joint ventures for a number of reasons. One such reason is to spread risk: while profits are also shared, potential losses are reduced when multiple parties are involved. Another reason companies enter into joint ventures is to leverage specific skills a partner possesses; similarly, a company may pursue a joint venture with a partner that has access or better information about a new market. Companies may also enter into joint ventures to leverage efficiencies resulting from economies of scale.

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.

Under the equity method, the investing company records an initial investment in another company as an asset on its books. In succeeding periods, the subsidiary company’s net income or net loss is multiplied by the investing company’s ownership stake, and the portion of income or loss attributable to the investing company increases or decreases the investing company’s investment asset. Dividends distributed by the subsidiary are considered a return of invested capital and reduce the investing’s company’s investment in the subsidiary company. This ownership accounting method is considered appropriate in situations where the investing company does not own the majority of the subsidiary, but exerts substantial influence; if Wendy’s owned the majority of the joint venture, they
would consolidate TimWen’s financials, if Wendy’s did not exert substantial influence, the investment method would be more appropriate.

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?

In many cases, when one company invests in another company, the investment exceeds the book value of the subsidiary company’s assets. In these situations, a two-step process is employed to account for this amount under the equity method. First, the subsidiary company’s assets are written up from their book value to fair market value. If the investment amount still exceeds book value, the remaining difference is then recorded as goodwill.

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

Wendy’s reports two equity investments, one with Tim Horton’s Incorporated (THI) and one labeled “Joint venture in Japan.” The joint venture with THI is valued at $91,742,000 at the end of 2011, and $89,370,000 at the end of 2012. The joint venture in Japan is valued at $77,000 at the end of 2011 and negative $1,750,000 at the end of 2012. This information is included in Note 8, below Wendy’s consolidated financial statements.
E. Using information in Note 8, compare the amount recorded for Wendy’s investment in TimWen at December 30, 2012 with Wendy’s 50 percent share of TimWen’s equity at December 30, 2012. What accounts for the difference between these two amounts?

Wendy’s records a $89,370,000 investment in the TimWen joint venture on December 30, 2012. TimWen’s assets attributable to Wendy’s on December 30, 2012 were $35,282,000. Wendy’s investment exceeds the value of TimWen’s net assets by $54,088,000. Wendy’s says in their notes to the financial statements that this difference is “primarily due to purchase price adjustments from the Wendy’s merger.”

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

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

In 2011 and 2012, Wendy’s investment in the TimWen joint venture increased their earnings before taxes. This appears on Wendy’s consolidated statement of operations under “operating expenses, net.”

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Income</td>
<td>13,680,000</td>
</tr>
<tr>
<td>Investment Income</td>
<td>13,680,000</td>
</tr>
</tbody>
</table>
iii. What is the amount of the amortization of the purchase price adjustments in 2012? Prepare the journal entry to record the amortization of the purchase price adjustments for 2012.

Amortization of purchase price adjustments total $3,129,000 in 2012. This amount would be recorded in this manner:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Income</td>
<td>3,129,000</td>
</tr>
<tr>
<td>Equity Investments</td>
<td>3,129,000</td>
</tr>
</tbody>
</table>

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

Wendy’s received $14,942,000 in dividends from TimWen in 2011, and $15,274,000 in dividends in 2012. The journal entry to record the dividends in 2012 is recorded in this manner:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>15,274,000</td>
</tr>
<tr>
<td>Equity Investments</td>
<td>15,274,000</td>
</tr>
</tbody>
</table>

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

i. The operating activities section of the statement of cash flows reports a negative adjustment for “Equity in earnings in joint ventures, net” of $8,724 in 2012. Reconcile this amount to the information disclosed in Note 8. Explain why a negative adjustment is made to arrive at net cash from operating activities.
A negative adjustment to cash flows from operating activities is made to reduce cash flows by the amount already recognized in net income. Cash received from dividends is reported separately, so an adjustment must be made to correct cash flows for the change in equity that does not affect cash. This reduction of $8,724,000 is arrived at by subtracting the $1,750,000 loss on the joint venture in Japan from the $10,551,000 in income realized from the TimWen joint venture.

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

As discussed above, a $15,274,000 positive adjustment is made to arrive at net cash from operating activities. This number represents distributions by TimWen to Wendy’s in 2012. This number must be added to cash flows because Wendy’s records it elsewhere as a reduction in the value of their investment in TimWen; in terms of cash flows, though, these distributions represent cash received, resulting in a positive adjustment.
Case Ten - Johnson & Johnson, Inc.

Accounting for Pension Obligations

Prepared by Ben Bradford

April 19, 2019
Executive Summary

This case centered on accounting for pension obligations, using the example of Johnson & Johnson’s pension plan. Pension plans are a benefit program offered by many companies. Though they vary in detail, pensions are benefits that employees receive after retirement. In some cases, employees make voluntary contributions; in others, all contributions to the pension plan are made by the employer on the employee’s behalf. These contributions are lumped into pension plan assets, which are then invested to (hopefully) generate a return. Favorable tax treatment and ease of saving make these plans popular.

Issues covered in the case include all the elements of pension accounting, including estimating pension obligation, where to find interest cost, service cost, and pension expense in the financial statement, and how pensions are documented. Pension accounting is complex and relevant- as the “Baby Boomer” generation grows older, pension obligations will continue to balloon, stressing poorly performing companies. I think this case expanded my understanding of this area of accounting.
Case Analysis

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

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

There are two types of pension plans—defined benefit plans and defined contribution plans. Defined benefit plans guarantee employees a set amount in payments after retirement, typically dependent on the highest rank reached before retirement. These plans are more common in government work than the private sector. Defined contribution plans, on the other hand, offer no guarantees about payment after retirement, but only charge a fixed amount while the employee is working—thus, “defined contribution.”

ii. Explain why retirement plan obligations are liabilities.

Retirement plan obligations are liabilities because they represent probable future financial obligations resulting from current transactions. The company records these obligations at their present value.

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

A number of estimates and assumptions are necessary in order to account for retirement plan obligations. For example, the company recording the obligation must be able to determine an estimate of the number of service years remaining before retirement for all employees. The company must also be able to calculate
the cost per employee after retirement, which requires more actuarial information regarding lifespan and other factors. Economic risk and return on plan assets must also be reasonably estimated. All of these are fairly difficult to estimate accurately, and all must be measured for the retirement plan accounting to work effectively.

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.

Pension obligations are influenced by four main types of activities:

i. Service Cost- Service cost refers to the amount a company must contribute in a given period to meet future obligations.

ii. Interest Cost- Interest cost reflects the interest accumulated on the projected benefit obligation to be paid to employees in future periods.

iii. Actuarial Gains and Losses- Actuarial gains and losses are the result of changes in actuarial estimates related to service years’ remaining, employee benefits, and future economic factors.

iv. Benefits Paid- Benefits paid to retirees in the current period reduce the future pension-based obligation.
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.

Pension assets are influenced by three main types of activities:

i. Return on Pension Investments- This refers to changes in fair market value and dividends paid out from assets held for the pension plan.

ii. Company Contributions- Refers to cash paid by the company to the pension plan to fund future payments.

iii. Benefits paid to retirees- These are paid out of plan assets and reduce the pension based obligation.

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

For pension expense, “return on plan assets” is estimated at the beginning of the period, and this estimate is applied to plan assets to reduce market volatility. For pension plan assets, “return on plan assets” is actual return on plan assets in a given period. The former
is a forward-looking estimate of future market fluctuations; the latter is retrospective and shows actual financial return.

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

The primary difference between accounting for insurance and health-care benefits and accounting for pension-based obligations is that the latter involves recording a liability for future periods. Generally, payments of insurance and healthcare are considering a labor or salaries cost in the period in which they are incurred, not as a future liability.

F. Consider Johnson & Johnson’s pension expense detailed on page 61 of the company’s annual report. Note that the company uses the term “net periodic benefit cost” to refer to pension expense.

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

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

ii. Prepare the journal entry to record the service cost and interest cost portion of the 2007 pension expense.
To record service cost and interest cost, Johnson and Johnson would make the following journal entry:

Pension Expense $1,253
PBO $1,253

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

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

Johnson & Johnson records $12,002 million as the value of the company’s retirement benefit obligation at 12/31/2007. This value represents the present value of the company’s future retirement plan obligations.

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

The pension-related interest cost for the year 2007 was $656 million. This corresponds to a 5.63 percent interest rate. This rate appears reasonable.

iii. What amount of pension benefits were paid to retirees during the year? Did Johnson and Johnson pay cash for these benefits? How do the benefits paid affect the retirement plan obligation and the retirement plan assets?
Johnson & Johnson paid $481 million in pension benefits to retirees in 2007. Johnson & Johnson paid cash from plan assets. Benefits paid reduce both the retirement plan obligation and the retirement plan assets.

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

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

The value of Johnson & Johnson’s retirement plans assets at 12/31/2007 was $10,469 million. This amount corresponds to the fair market value of the assets held for the pension plan.

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

In 2006, expected return on plan assets was $701 million, and actual returns were $966 million. In 2007, expected return on plan assets was $809 million, and actual returns were $743 million. In my opinion, these differences are not significant. Expected returns better reflect the economics of the company’s pension expense because they “smooth out” market fluctuations.
iii. How much did Johnson & Johnson and their employees contribute to the retirement plan during 2007? How does that compare to contributions in 2006?

Johnson & Johnson and employees contributed $379 million to the pension plan in 2007. Johnson & Johnson and employees contributed $306 million to the pension plan in 2006.

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

The retirement plan consisted of about 79 percent equity securities and 21 percent debt securities.

I. Is the company’s retirement plan under funded or over funded at December 31, 2007? At December 31, 2006?

The company’s retirement plan was underfunded by $2,122 million at 12/31/2006. The company’s retirement plan was underfunded by $1,533 million at 12/31/2007.
Case Eleven: On the Balance Sheet-Based Model of Financial Accounting

Prepared by: Ben Bradford

April 28, 2019
**Executive Summary**

Ilia Dichev’s article “On the Balance Sheet-Based Model of Financial Reporting” develops a compelling argument that the current approaches of the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) place an undue emphasis on balance sheet accounting, which he considers a flawed approach for a number of reasons.

Dichev begins his paper by making a distinction between the balance sheet approach to accounting and the income statement approach. The balance sheet approach considers the proper valuation of assets and liabilities to be the primary goal of accounting; under this view, earnings are determined by a change in the value of an organization’s net assets. This view is rooted in economics and is the one that FASB and the IASB have favored since the 1970s on the rationale that one must define value before one can define a change in value. Fair value accounting adjustments are a component of the balance sheet approach.

In contrast, the income statement approach considers determination of revenues, expenses, and earnings to be the primary goal of financial accounting. In this model, assets and liabilities valuations are secondary, and represent the cumulative value of accruals. This approach is favored by the finance community, which is more interested in future earnings and cash flows than the appropriate value of assets.

Dichev’s first complaint about the current FASB/IASB balance sheet approach is that this method of accounting is at odds with how businesses generally operate. He notes that in most businesses, assets are temporary and have little existence independent of the business processes they are used in. Moreover, businesses operate principally to earn revenue, and acquisition of
assets is not a goal but a side effect of earning revenue. Dichev notes that managerial accounting is almost purely concerned with projected revenue and costs, and the finance community generally operates on the same assumptions. Considering assets to be stores of value, he argues, distracts attention from the more important results of business operations. In his view, business is a process, not a collection of assets.

Dichev’s second grievance addresses the purported primacy of assets as a foundation of accounting. FASB and the IASB’s rationale for using the balance sheet approach is rooted in logical foundations- they argue that defining what an asset or value is must occur before one can define what revenue or a change in value are. Dichev disagrees here and points out that the value of assets is determined by the future earning potential of that asset, not some intrinsic characteristic; therefore, earnings are equally or even more crucial to the accounting system than assets. He continues to note that it’s much easier, conceptually, to determine when a business is making money than to determine the value of all of that business’s tangible and intangible assets.

Dichev’s third and fourth complaints about balance sheet accounting consider how that approach makes earnings less useful for end users of financial information. Because balance sheet accounting results in frequent adjustments to the fair value of assets, which often have no relation to the firm’s operating earnings, this approach makes earnings less relevant. Dichev notes that changes in accounting methods over the past forty years have made earnings less relevant for investors, and further argues that the declining value of earnings has led directly to the rise of non-GAAP indicators of performance like adjusted EBITDA. He further notes, in his final point, that the use of fair value accounting creates a dangerous feedback cycle between firm value and market performance: As the overall market grows, the fair value of assets increases,
which generates higher balance sheet approach earnings, which in turn causes the entire market to grow. He cautions that this cycle could exacerbate market cycles if left unchecked.

Dichev ends his article with a couple of proposals to resolve the shortcomings he describes. First, he proposes that FASB and the IASB create a theoretical distinction between “Operating” activities and “Financing” activities. Operating activities would relate to the general operation of businesses, where assets are peripheral. Fair value adjustments would not occur to these assets. Financing activities would involve non-recurring events and transactions, and fair value adjustments would be made here if the assets are cash-equivalent or have clear market values. Each of these categories would have a separate bottom line on the income statement, so end users of financial information could distinguish between earnings from regular business operations and earnings from adjustments to asset values. Dichev’s other suggestion is more abstract; he calls for a renewed emphasis on the matching principle. Aligning expenses as closely as possible to revenues, he says, would more closely align accounting with how businesses actually operate and create value.
How did reading this article change your current way of thinking?

This article was enormously helpful in clarifying my understanding of financial accounting. I agree with Dichev’s points wholeheartedly. In my experience as an accounting undergraduate, my favorite classes thus far were Accounting 202 and Cost Accounting, both of which primarily concerned managerial accounting. I’ve always felt that the information in those classes was “more relevant” to actual business operations than, say, Intermediate I or II. After reading Dichev’s article, I understand why: Those classes were covering revenues, expenses, and income statement accounting! In contrast, fair value adjustments seemed needlessly convoluted and irrelevant— I’m glad I’m not alone in that feeling.

Dichev repeatedly makes the argument that accounting methods should reflect how businesses operate, and it’s this point that I think is his strongest. In the majority of cases, continuing businesses have very little interest in the fair market value of their assets. The value of a piece of equipment, building, or plot of land is not really relevant to a company’s operations, so why should accounting methods act as if the appreciation or depreciation of these assets has any bearing on the day-to-day operations of the business? Dichev makes a further case for businesses with large intangible assets using the example of Microsoft. What intangible does one attribute Microsoft’s earnings to: market leadership, goodwill, employee knowledge? The answer is that the market value of each intangible doesn’t really matter to Microsoft’s leadership, only the net amount of revenues and expenses. The same argument could be made for nearly any business: what difference does the value of assets make if you don’t intend to dispose of them and you’re making money?

Dichev’s argument reminds me of a crucial theory in economics: Carl Menger’s subjective theory of value. The subjective theory of value holds that assets are only as valuable
as what any one actor is willing to pay for that asset; assets have no internally intrinsic value beyond what anyone is willing to trade to get that asset. This is where fair value adjustments seem to lose relevance, in my mind. Unless there is an active trading market for a given asset, fair value adjustments seem like a dangerous realm in which management can create illusory growth (Dichev notes that this happened on a massive scale at Enron). A far safer bet would be to record assets at historical cost and disregard changes in market value, particularly if the company has no intent to dispose of an asset.

Ultimately, Dichev has made a convert out of me to the church of income statement accounting. I think his criticisms of the current state of accounting have enormous merit, and I hope that his complaints do not fall on deaf ears. Financial accounting is for the end users of financial information, and all efforts should be made to produce the most relevant and useful information for those users.
How will you use this information in your future career? Be thoughtful and creative about the situations you will encounter where this article will affect your beliefs and the way you carry out your future job.

In public accounting, I think Dichev’s paper will make my use of fair value adjustments more judicious regarding how I value assets. Given the choice, I don’t think I would elect to make use of the fair value option in those cases, where such a choice is optional, and it is my decision to do so. In situations where the fair value option must be used, or some other person has made the decision already, I would be considerably more judicious about adjusting the value of a given asset. If a piece of land had appreciated substantially, for example, I would be cautious and employ conservatism in my adjustment. If the company has no intent to dispose of the land, I would be especially skeptical of making the adjustment at all.

As a potential worker in deal advisory or the financial community, I would be using financial information rather than producing financial statements. Dichev’s paper makes me absolutely more skeptical of earnings as an indicator of future performance within a business unit. If I was working in a finance or a deal advisory capacity, I would now put little value in the usefulness of earnings and would instead search for other (non-GAAP) metrics, particularly EBITDA and adjusted EBITDA. These would provide a better indication of the company’s future ability to generate revenues than the current state of earnings on the income statement.

My career end goal is to work in corporate management, and Dichev’s impact here is most obvious. As he explains in his paper, the balance sheet approach is at odds with how businesses are actually operated; most businesses, he explains, are not interested in asset valuations but revenues and expenses. As a Chief Financial Officer or Comptroller my main focus would be on providing cost-benefit analyses for potential business decisions. As Dichev
notes, the fair value of assets is irrelevant in a cost-benefit analysis, and the user is only interested in revenues and expenses (and the timing of cash flows). After reading Dichev’s paper, my approach to managerial accounting would spend even less time concerned with balance sheet valuations; my focus would shift almost entirely to profit and loss statements and income statement accounting.
Case Twelve- Google Inc. and Earnings Announcements

Prepared by: Ben Bradford
May 1, 2019
Executive Summary

Issuing financial statements is often a balancing act between presenting an attractive picture for potential investors and conforming to the rules set by standard-setters like the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB). Financials that fully conform to these standards may not convey the message that management intends to deliver to financiers, particularly if the company spent a material amount on one-time expenses or the company is experiencing rapid growth. In these instances, the company may append their fully compliant financial statements with non-GAAP financial information, provided they reconcile those figures to the accepted accounting.

This case centered on the effects of earnings reporting on a company’s stock price. Topics explored within this case included the use by investors of non-GAAP financial information, how the timing of information influences stock prices and company valuations, and how firm performance is evaluated.

This case used the financial statements of Google, Inc. for their fiscal year 2013 and associated information to demonstrate how financial disclosures affect stock price. Google used non-GAAP supplementary financial statements to eliminate losses from discontinued operations and neutralize the effects of stock-based compensation. Google’s stock price rose steadily in 2013.

The information included in the case included the company’s actual financial information, the opinions of Google Inc.’s management, and the opinions of analysts (in the form of a Wall Street Journal article).
Case Analysis

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

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

Google’s reconciliation from GAAP to non-GAAP earnings involves eliminating stock-based compensation, eliminating restructuring charges, eliminating income tax effects of the two prior changes, and eliminating a net loss from discontinued operations. Although there is no consensus on what adjustments are made to arrive at non-GAAP measures of net income, the general intent when these figures are produced is to eliminate one-time adjustments or events with no bearing on company profitability to arrive at a more reasonable approximation of future earning potential. Through this lens, Google’s adjustments make sense to me. Stock-based compensation, for example, does not impact company profitability, and adding this amount back to net income creates a better indication of performance. Likewise, a net loss from disposal of a division is an expense that is only incurred once, and assumptions about future performance would be incorrect if one did not adjust for such an event.
I. Use the attached stock-market charts for Google for the period January 1, 2013, through February 14, 2014, to answer the following questions.

i. Compare Google’s fiscal 2013 earnings performance with the movement in Google’s stock price over 2013.

Google’s earnings in fiscal 2013 were higher than their earnings in fiscal 2012, and the movement of their stock price reflected these results. Google’s stock price rose by more than 60 percent over their fiscal 2013 year.

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

Google’s stock price mirrored the NASDAQ index for the first three quarters of the year. When Q3 earnings were released in October, Google’s stock price surged, and stock price growth outpaced the rest of the NASDAQ index for the remainder of 2013.

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

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

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

Earnings are relevant to investors because they provide information about a company’s performance on a routine basis. In addition to providing information about past performance, earnings provide a basis for estimates of future financial performance, which are then used by investors to estimate a company’s value. According to the article, Google’s fourth quarter revenue exceeding analyst expectations, but earnings were slightly less than expectations due to stock compensation. This result is consistent with the market’s reaction, as Google’s stock price rose.

ii. What other factors does the article discuss that might contribute to the market’s positive reaction to the earnings press release? Are there any factors that might cause investors to be concerned about Google’s recent performance?
The article attributes Google’s strong stock market performance to the news to two factors: First, that the company was able to grow ad revenue despite challenges, and secondly, Google’s decision to dispose of an unprofitable Motorola division. Advertising is a Google’s primary source of revenue, so news that Google was able to grow revenue in this department, despite a shift to mobile devices and new platforms for advertisements, was welcome news for investors; as a result, Google’s stock became more highly valued, and the company’s stock price rose.
Bibliography

Case One


