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A COMPREHENSIVE REVIEW OF ACCOUNTING TOPICS THROUGH CASE STUDIES AND ANALYSIS

By
Delaney Nicole White

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

Oxford, MS
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ABSTRACT

Delaney Nicole White: A Comprehensive Review of Accounting Topics through Case Studies and Analysis

This thesis encompasses the information gathered through a series of twelve accounting case studies that I completed throughout the 2018-2019 school year. These case studies explore various accounting theories and concepts within financial reporting and accounting as well as situations that I may find myself faced with in the short term. The case studies required the application of concepts learned over several accounting courses to realistic scenarios and real-life examples and the development of skills to analyze software and complex accounting transactions.

The case studies included topics such as accounting for contingencies, joint venture and equity method investments, pension accounting and retirement obligations, and analysts' expectations and public company earnings releases. For these studies, a detailed review of companies' balance sheets, income statements, statements of cash flows, as well as the notes to the financial statements was necessary. I learned the extent of supplementary information that companies disclose within their 10-Q and 10-K footnotes. Detailed analysis of companies footnotes and tracking on how the footnotes were changed and updated over time, in addition to the financial statements, supported my research. In addition, some of the case studies delved into personal decisions and situations such as determining which city to pursue an accounting career in, considerations of law degrees versus accounting degrees when it comes to tax accounting, and our thoughts on audit firms current focus on the balance sheet versus the income statement. This research expanded my knowledge of challenging accounting concepts and prepared me for my career in public accounting.

Preparing the case studies improved my researching skills and knowledge of current and complex accounting topics and how they impact companies today. It also gave me insights into the challenges faced by public accountants as many of the issues were not black and white, but involved significant judgment, which with hindsight, was not always accurate. One of the main takeaways of my thesis is that public accountants and the companies they audit need to work together to ensure that they reach consensus on the stances they take on material matters, especially the matters which involve incomplete information and significant judgment calls. Knowing the intricacies involved in some of the highly technical accounting topics in these case studies encourages me to consult with others on my team and subject matter experts when faced with significant, material issues.

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Case #1: Caseware IDEA

This case study focuses on the Caseware Interactive Data Extraction and Analysis software tool (IDEA). The case provides a better understanding of the functionality of the tool, how it can be utilized and why training is a key part of the decision to use it. Some refer to IDEA as a "tool designed to help accounting and financial professionals extend their auditing capabilities, detect fraud and meet documentation standards" (audimation.com). IDEA assists analysts in gathering the data and performing analysis to support better business decisions by making it easy to import data from multiple sources. It also provides customizable scripts for many types of analytics and reporting findings in a variety of formats including Microsoft® Access®, XML, Text, Microsoft® Word, PDF, Microsoft® Excel® and pre-defined reports (casewareanalytics.eu). Instead of being buried in data, users can efficiently examine and present findings and make timely decisions.

Although Caseware International Inc. acquired IDEA in 2000, it remains a widely-used system. Case International stays current with continued improvements, as evidenced by the recent release of Version 10.3 (casewareanalytics.com). In addition, due to its long history, there are numerous resources, developed scripts, examples and guides available covering uses of the software.

Learning how to evaluate different tools against each other and against existing, manual methods remains a skill that I believe I will use many times in my future career. Whether assisting public accounting clients or later in an industry job, I believe defining requirements and determining if a tool satisfies those requirements will be key in investing time and money in the right tool.

Based upon my research, it appears that IDEA is a reliable tool that has been vetted by thousands of users over many years. For a company that wishes to move from manual review processes to more modern methods of analysis, IDEA is a logical step. My research revealed many ways that auditors, tax accountants and financial analysts could use IDEA to identify areas of concern and work more efficiently.

a. Identify the purpose of this tool and describe, in general, how it is used to make business decisions. Be specific about other resources that need to be in place to fully utilize the functionality of the tool.

IDEA broadens the reach of finance, accounting and audit professionals beyond what manual analysis could evaluate. Due to the sheer quantity of data available in a typical Enterprise Resource Planning (ERP) system, individuals using manual methods could quickly get lost in numbers without the ability to accomplish a meaningful or complete analysis. After importing data from all the key sources, users can use scripts that are pre-built in IDEA or custom develop their own scripts to address their concerns and perform their analysis. The reporting abilities built into IDEA can transform large quantities of data into simple charts and graphs identifying problem areas that should receive more focus and enabling quick decision making.

Resources needed to utilize the functionality of the tool include employees who have been trained on the tool, potentially a dedicated server due to the quantity of data, access to and the ability to regularly obtain complete source data from the ERP or other systems, and a plan, supported by management, detailing what will be done with the results of the analysis. The analyses are not intended to be a point in time procedure, done once

and then forgotten. The analyses need to be repeated routinely so that norms, trends and outliers can be better identified.

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. Be sure to describe what kinds of data your tool would use for each scenario.

Auditing

1. IDEA can be utilized to detect non-compliance with the Foreign Corrupt Practices Act (FCPA). Accounts payable and employee expense report data can be imported into the tool. Scripts related to the top FCPA risk factors can be utilized to create a list of higher risk transactions to be reviewed in detail. Examples include scripts to pull even dollar transactions, key word searches (i.e. gift, official and donation), and new vendors. As the highest risk of FCPA violations often falls in foreign locations, users get the added benefit that the work can be completed remotely. Manual reviews will be focused on transactions that trigger two or more of these risk factors.
2. Neither employers nor employees tolerate payroll mistakes well. Using IDEA to efficiently check every pay run could prevent numerous errors. A quick test would be comparing the current payroll against the previous payroll and pulling added or deleted employees for review against new Human Resource records. This same comparison could be used to look for uncalled for changes in gross pay, hourly rates or benefit withholdings by employee. In addition, the payroll department could compare time card rates to payroll to look for variances. The accounts payable

department could also use IDEA to compare employee social security numbers, phone numbers, and addresses to accounts payable vendor information to identify potential fraud.

3. Companies and the auditors are both focused on controlling inventory. Internally, companies can use IDEA to track on inventory expiration dates and work to avoid scrap costs. Also, to order efficiently, companies can use IDEA to compare count quantities to the minimum amount of product that they have determined must be on hand always, thus avoiding both shortages and excessive storage costs. When preparing for an audit, companies with perpetual inventory records often focus on inventory cycle count controls. IDEA can be used to create an inventory cycle count dashboard to track on the timeliness and accuracy of cycle counts.

Tax Planning

1. During my internship this summer, I could have used IDEA on the Texas Tax Amnesty project that I worked on. Had all the company's invoices been entered into their operating system (QuickBooks) correctly, I could have uploaded the data straight from the source and used IDEA to analyze the transactions for sales tax paid much more efficiently.
2. That tax and accounts payable departments can both benefit from using IDEA to review the reasonableness of sales tax charged in all accounts payable transactions. IDEA can import and compare all of accounts payable transactions each month to determine if the tax paid is within normal tax ranges.

3. While preparing corporate tax returns, tax accountants can use IDEA to compare book and tax depreciation. They can then check to ensure that differences between the two are correct and in line with tax regulations.

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: Office Managing Partner

From: Delaney White

Date: 9/5/18

Re: Caseware IDEA Training

Background

I applaud your decision to purchase the IDEA tool for use in our audits in the future. I wanted to take this opportunity to stress how important training our audit staff on the use of IDEA will be.

Resources

IDEA training is available live, on-line or through on-demand courses at our office. The training courses also quality for CPE credits. Please see https://www.casewareanalytics.com/training for details and options.

Discussion

One of the key advantages of IDEA is that it can be used by non-IT staff, without programming expertise. Our IT Group has other responsibilities and is only in the field at our audit clients for one or two weeks a year. Training our audit staff, those that are at the client site and surrounded by the client data year-round, will increase the use of the tool exponentially. Focusing the audit effort on higher risk transactions will prevent our audit teams from wasting time on non-specific audit procedures. If even one team member on each audit engagement could be trained on IDEA, I believe that we would reap many benefits. During the planning phase of the audit, that individual could brainstorm with the team to identify specific IDEA analyses that could be utilized for high risk audit areas and areas that have been challenging to audit efficiently in the past. This time spent during the planning phase, outside of busy season, can decrease the hours we spend on the engagement.

Conclusion

IDEA is a powerful tool and if we make it available to all our audit teams I believe that you will see a return on your investment in the tool for both our clients and our staff.

Case #2 - Rocky Mountain Chocolate Factory, Inc.

Summary:

This case required us to evaluate several transactions of the Rocky Mountain Chocolate Factory and prepare the related journal entries. This required an understanding of basic accounting principles as well as how debits and credits affect assets, liabilities, equity, revenue and expense accounts. The case also reinforced my grasp of the linkages between the balance sheet accounts and income statement accounts. It also required differentiating between cash and accrual-based accounting, understanding that the timing of payment impacts which balance sheet accounts are affected, and how different events impact assets and liabilities. The case also asked that I prepare the year-end financial statements, which required a closing entry for the temporary accounts as I closed the income statement accounts into retained earnings.

Not all the lessons learned from this case study were related to accounting. Through this case I also learned to use Microsoft Excel more efficiently and effectively. I realized that having check figures for each transaction can prevent manual errors and that formatting can be time intensive, but that it is important to make it easier for the users of the financial statements to quickly follow the balance sheet and income statement. I will use these skills not only in future cases but in the work force as well.

Concepts:

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

Rocky Mountain Chocolate Factory, Inc. is not only a confectionary manufacturer, but also an international franchiser and retail operator in several countries. I expect to see all of the typical permanent accounts on its balance sheet. Major assets should include cash, accounts receivable, inventory and property and equipment. Major liabilities should include accounts payable, other accrued expenses and deferred income from franchisees.

Process:

e. Based on the transactions you recorded in parts b and c, list at least three adjustments or reclassifications that might need to be made prior to preparing the final financials statements.

1. Splitting deferred income from new franchisees (from transaction #8) between current and long-term liabilities
2. Checking for necessary adjustments to deferred income taxes based upon the income earned and adjustments made
3. Adjusting current and non-current notes receivable, to ensure the current balance only includes items due in 12 months or less

Rocky Mountain Chocolate Factory , Inc.
General Journal

	Accounts	Beginning balance (February 28,2009)	1. Purchase Inventory	2. Incur Factory wages	3. Sell inventory for cash and on account	4. Pay for inventory	5. Collect receivables	6. Incur SG&A (cash and payable)	7. Pay wages	8. Receive franchise fee	9. Purchase PPE	10. Dividends declared and paid	All other transactions	Unadjusted Trial Balance	12. Adjust for inventory count	13. Record depreciation	14. Wage accrual	15. Consultant's report	Preclosing trial balance	16. Closing Entry	Post-closing (ending) balance	Actual February 28, 2010 F/S figures
Dr.	Cash and cash equivalents	1,253,947			17,000,000	(8,200,000)	4,100,000	(2,000,000)	(6,423,789)	125,000	(498,832)	(2,403,458)	790,224	3,743,092					3,743,092		3,743,092	3,743,092
	Accounts receivable	4,229,733			5,000,000		(4,100,000)						(702,207)	4,427,526					4,427,526		4,427,526	4,427,526
	Notes receivable, current	-											91,059	91,059					91,059		91,059	91,059
	Inventories	4,064,611	7,500,000	6,000,000	(14,000,000)								(66,328)	3,498,283	(216,836)				3,281,447		3,281,447	3,281,447
	Deferred income taxes	369,197											92,052	461,249					461,249		461,249	461,249
	Other	224,378											(4,215)	220,163					220,163		220,163	220,163
	Property and Equipment, Net	5,253,598									498,832		132,859	5,885,289		(698,580)			5,186,709		5,186,709	5,186,709
	Notes receivable, less current portion	124,452											139,198	263,650					263,650		263,650	263,650
	Goodwill, net	1,046,944												1,046,944					1,046,944		1,046,944	1,046,944
	Intangible assets, net	183,135											(73,110)	110,025					110,025		110,025	110,025
	Other	91,057											(3,007)	88,050					88,050		88,050	88,050
Cr.	Accounts payable	(1,074,643)	(7,500,000)			8,200,000							(503,189)	(877,832)					(877,832)		(877,832)	(877,832)
	Accrued salaries and wages	(423,789)		(6,000,000)					6,423,789					-			(646,156)		(646,156)		(646,156)	(646,156)
	Other accrued expenses	(531,941)						(3,300,000)					2,885,413	(946,528)					(946,528)		(946,528)	(946,528)
	Dividend payable	(598,986)										(3,709)	1	(602,694)					(602,694)		(602,694)	(602,694)
	Deferred income	(142,000)								(125,000)			46,062	(220,938)					(220,938)		(220,938)	(220,938)
	Deferred Income Taxes	(827,700)											(66,729)	(894,429)					(894,429)		(894,429)	(894,429)
	Common Stock	(179,696)											(1,112)	(180,808)					(180,808)		(180,808)	(180,808)
	Additional paid-in-capital	(7,311,280)											(315,322)	(7,626,602)					(7,626,602)		(7,626,602)	(7,626,602)
	Retained earnings	(5,751,017)										2,407,167		(3,343,850)					(3,343,850)	(3,580,077)	(6,923,927)	(6,923,927)
	Sales	-			(22,000,000)								(944,017)	(22,944,017)					(22,944,017)	22,944,017	-	(22,944,017)
	Franchise and royalty fees	-											(5,492,531)	(5,492,531)					(5,492,531)	5,492,531	-	(5,492,531)
Dr.	Cost of sales	-			14,000,000								693,786	14,693,786	216,836				14,910,622	(14,910,622)	-	14,910,622
	Franchise costs	-											1,499,477	1,499,477					1,499,477	(1,499,477)	-	1,499,477
	Sales & marketing	-						1,505,431						1,505,431					1,505,431	(1,505,431)	-	1,505,431
	General and administrative	-						2,044,569					(261,622)	1,782,947			639,200		2,422,147	(2,422,147)	-	2,422,147
	Retail operating	-						1,750,000						1,750,000			6,956		1,756,956	(1,756,956)	-	1,756,956
	Depreciation and amortization	-												-		698,580			698,580	(698,580)	-	698,580
	Interest income	-											(27,210)	(27,210)					(27,210)	27,210	-	(27,210)
	Income Tax Expense	-											2,090,468	2,090,468					2,090,468	(2,090,468)	-	2,090,468
	A = L + OE + R - E	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	

Rocky Mountain Chocolate Factory , Inc.
Income Statement
For the Year Ended February 28, 2010

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

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

Assets		
Current Assets		
Cash and cash equivalents	$	3,743,092
Accounts receivable		4,427,526
Notes receivable, current		91,059
Inventories		3,281,447
Deferred income taxes		461,249
Other		220,163
Total current assets		12,224,536
Property and Equipment, Net		5,186,709
Other Assets		
Notes receivable, less current portion		263,650
Goodwill, net		1,046,944
Intangible assets, net		110,025
Other		88,050
Total other assets		1,508,669
Total assets	$	18,919,914
Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts payable	$	877,832
Accrued salaries and wages		646,156
Other accrued expenses		946,528
Dividend payable		602,694
Deferred income		220,938
Total current liabilities		3,294,148
Deferred Income Taxes		894,429
Commitments and Contingencies		
Stockholders' Equity		
Preferred stock, $.10 par value; 250,000 authorized; shares issued and outstanding		-
Common Stock		180,808
Additional paid-in-capital		7,626,602
Retained earnings		6,923,927
Total stockholders' equity		14,731,337
Total liabilities and stockholders' equity	$	18,919,914

Rocky Mountain Chocolate Factory , Inc.	
Cash Flow Classification	
Purchase Inventory	Operating
Incur Factory Wages	Operating
Sell Inventory	Operating
Pay for Inventory	Operating
Collect Receivables	Operating
Incur SG&A	Operating
Pay Wages	Operating
Receive franchise fee	Operating
Purchase PPE	Investing
Dividends declared and paid	Financing
Adjust for inventory count	Operating
Record depreciation	Operating
Wage accrual	Operating

Case #3: Transparency is Key

This case focused on real life situations that we, as accounting majors, may face in the near future. Three scenarios were presented to us in class, and it was our job to pick a side and argue our position. These scenarios were all based on conversations overheard by Dr. Dickinson or real-life situations brought to her attention. It is important to play through situations like these, develop your decision-making skills and determine what your position would be so that you will be prepared to adapt your plans if need be.

The first case was a conversation between two students – both of which were accounting majors, but one with aspirations to go into tax law and continue onto law school. The argument was whether law school or the Masters of Accounting program would be more fitting. I sided with going to law school. Although the Master's program would be less of a time and financial commitment than law school, I feel that it would be less appealing to future employers. Although students who go the Masters of Accounting program route would have a two-year head start to their career due to the time commitment required of law school, students who work for law firms as tax lawyers quickly close the gap made by those two years. They have the potential to make more money with law degrees working at law firms as opposed to accounting degrees.

I personally know several students who are majoring in accounting and will intern with accounting firms, but plan to enroll in law school upon graduation. Although, it may seem unfair for students who have no intention with sticking with the accounting firm to take up those internship spots, internships with law firms are harder to find so they take the opportunity presented to them to gain valuable experience. It is also beneficial to the student that the degree path between the accounting and tax law programs is very similar and there is a lot of overlap.

In Scenario 2, several students discussed their plans to use the accounting school as a stepping stone to instead go into investment banking and consulting. At Ole Miss in particular, the accounting school is much stronger than the business school and the accounting school's strong reputation brings more entry-level opportunities for students. In addition, an accounting degree is more versatile and can be used in all types of business. It is not uncommon for accounting majors to leave their jobs at the Big Four after a few years to pursue all different types of careers, so leaving to pursue investment banking or consulting would be no different. Although it may seem inconsiderate to abandon the firms after they have invested a bunch of time and money recruiting and training you, the same firms have large consulting practices and would be interested in these candidates with Big Four accounting experience.

In the third scenario, a student completed their internship with one of the Big Four in Washington D.C., but is now hoping to transfer home to Dallas for their permanent position. I find this situation to be the most relatable. It is very difficult as a junior in college to decide where you want to live 3 years from now. While circumstances may change, such as a family member's health or your happiness, it is important to put a lot of time and thought into your internship location decision. The firms invest about $175,000 to get you recruited and through an internship and will not make a profit off your work until at least two and a half years have passed. I believe you owe it to the firm to try your best and stick it out through that time frame out and pay some of that back.

It is unlikely that firms will often have transfer openings right away, but expressing your desire to transfer and your willingness to wait until it is convenient for the firm that has invested in you, could result in a successful transfer. The firms want you to stay with

them, especially after all they did to recruit you, so if allowing you to transfer between offices increases retention, they should be open to relocation. Leaving the firm completely would hurt the firm as a whole. Most students who completed their internship in that city will be returning for their full-time positions in the fall, which leaves little room for transfers. Personally, I hope to intern and eventually work in my hometown of Austin, Texas where spots are especially coveted as the Big Four offices are smaller there and both the University of Texas and Texas A&M have strong students competing for spots. Some firms may not be able to help you right away, but if you are able to show your commitment, are a highly-ranked performer and stick it out for six months to a year, they will be much more likely to want to help you. It is very important to be transparent with the firm as soon as you have the desire to transfer instead of waiting until a few months before you are supposed to report back for your full-time position. At that point, there is very little the firms will be able to do for you until more time has passed, and spots have opened up.

This case started conversations about very important situations that any of us could find ourselves in and it is important to recognize that they could happen to you and that you would need to carefully consider the options. Firms are made up of people that once were in our shoes and have been through some of the same situations. If you approach these situations with honesty and transparency with both yourself and the firm, you are likely to be successful. I will take the lessons learned from these scenarios and carry them with me into the work force.

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

This case focused on a complex situation facing a bank, its CFO and it auditors. Banking is a much-regulated industry and banks are required to maintain strict capitalization thresholds and ratios. In that environment, banks rarely make decisions without examining all the possible consequences. This case study centered on a security sales transaction and its effect on Generic Bank's financial statements. Two questions were initially proposed in the case study and three additional questions were proposed based upon our answers to these initial questions. These questions demonstrated how a change in circumstances or timing can easily alter how an assumption or the accounting for a transaction is affected, resulting in differing financial results.

Background:

Toward the end of 20x2, Joshua Winters, Generic Bank's CFO, expressed a desire to free up cash by selling available for sale (AFS) debt securities. Generic Bank's investment portfolio contained material unrealized losses. The securities portfolio of the bank was in a net loss position with most of the unrealized losses related to mortgage backed securities and with roughly 60 percent of the losses having been in an unrealized loss position for over 12 months.

Previously, the bank had identified all its securities as AFS and had determined that the securities were not impaired: 1) as the bank represents that the decline in fair value was not due to credit losses, but instead was due to rising interest rates, and 2) that the bank had the intent and ability to hold the securities until they could recover their losses. With the new, potential plan to sell some of their AFS securities, Generic Bank might still have had the ability to hold the securities until they recovered, but they might no longer have had the intent.

Guidance:

- ASC 320, which falls under FASB Subtopic 825-10, establishes standards of financial accounting and reporting for all investments in debt securities, including debt instruments that have been securitized.
- ASC 326-30 was established by FASB guidance issued in ASU 2016-13 and changed the impairment guidance for most financial assets that are measured at amortized cost from an incurred loss model to an expected loss model and changes how companies are to record credit losses on AFS debt securities. As this update does not take effect until 2020 for SEC filers and in 2021 for all other entities including public business entities other than SEC filers, this guidance will not be used for this case study.
- ASC 855-10 provides guidance on principles and requirements for subsequent events.

Discussion:

Based upon the guidance, a debt security is impaired when its fair value is less than its cost. Entities are required to assess whether such impairment is other-than-temporary every quarter for public companies such as Generic Bank. Debt securities with the same CUSIP number, even if purchased on different dates, can be combined for evaluating impairment if the entity groups the securities for purchases of measuring realized and unrealized gains and losses. If an entity intends to sell the debt security, an other-than-temporary impairment shall be considered to have occurred.

At acquisition, an entity is required to classify each security into one of three categories:

- Trading — Debt and equity securities held primarily to be sold in the near term

- Held to maturity — Debt securities for which management has both the intent and ability to hold until maturity
- Available for sale — Debt securities not classified as held to maturity or trading

The classification of each security will determine the subsequent measurement basis (i.e. amortized cost versus fair value) of the security and how it will be presented and disclosed in the financial statements.

These classifications are important for this case as AFS securities are recorded at fair value. Although that means that the Bank's balance sheet shows the lower fair value for their debt securities that are in an unrealized loss position, these unrealized losses are not included in earnings immediately, but instead are included in accumulated other comprehensive income, until the losses are realized or until the unrealized loss is considered other-than-temporary. This determination of whether Generic Bank's unrealized loss for these seven securities is other-than-temporary at the end of 20x2 and would then run through earnings in 20x2 is a main part of this case study.

The guidance that addresses this key question states that in order for an impairment to be considered temporary, management must assert that it does not intend to sell prior to recovery of the debt security's amortized cost basis. The subsequent sale of the seven debt securities at a loss right after year end raises the question of when Generic Bank decided to sell. According to the guidance, for sales at a loss shortly after the balance sheet date, entities should document when the decision to sell was made, by whom and describe the factors that drove the decision to sell. As the seven debt securities the CFO had identified were in an unrealized loss position, an other-than-temporary loss would be expected when the decision was made and should be recognized in net income at an amount that is equal

to the entire difference between the seven debt securities amortized cost basis and their fair value.

In addition, it needs to be considered if the sale of the seven securities shortly after year end represents a Type I subsequent event. A Type I subsequent event consists of event that occurred at the financial statement date, but may have concluded after year end. This affects the estimates used when preparing the financial statements. All information that becomes available before the financial statements are issued or filed should be used by management in its evaluation and the financial statements should be adjusted for changes in the estimates.

Questions and Conclusions:

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

Based upon the Case Study discussion that 1) Joshua Winters, the CFO of Generic Bank, began considering selling the available for sales debt securities before the end of 20x2, 2) identified seven specific securities for sale with their CUSIP numbers near the end of 20x2, and 3) did sell the identified specific securities shortly after year end, it is my belief that Generic Bank did have an impairment loss on the seven securities as of 12/31/20x2. I believe that the bank had the intent to sale the securities prior to year-end.

If the CFO, CEO and any others stated that they did not intend to sell the seven assets at year end, documented when the decision to sell was made, by whom and described the factors that drove the decision to sell, I would consider if the impairment loss should be delayed until the decision was finally made in 20x3.

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

No, while I believe that the other securities are impaired as their fair value is less than its amortized cost, I do not believe that Generic Bank has an other-than-temporary impairment loss on the other securities due to two reasons. First, Generic Bank was not forced to sell the seven securities and I believe retains the ability and intent to hold the other securities until they have recovered a value equal to or above their amortized cost. Second, as noted in the guidance above, unless the investments are in the same CUSIP number, they are not aggregated so the Bank does not have to consider the other securities in combination with the seven that were sold.

3. **Does your answer change if you assume the role of Heather Herring, the external auditor? Does your answer change if you assume the role of a bank regulator? What other factors might an external auditor or regulator consider in making their determination?**

   My above answer does not change if I assume the role of the external auditor or bank regulator as I was examining it from the view of my stance being supportable for the audit. Signed statements and internal bank documentation supporting when the decision to sell was made, detailing by whom the decision was made and describing the factors that drove the decision to sell would be factors that an external auditor or regulator might consider in making their determination.

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

First, the securities would not be impaired as the fair value would not be below the amortized cost; therefore, no write-down or impairment would be necessary. If the securities sold had been in a net gain position, then a gain for the difference between the amount they were sold for and the amortized cost basis in those securities would have been recognized in net income in 20x3 when the securities were sold. In addition, on the date of sale, any unrealized gain or loss related to those securities that had previously been recorded in accumulated other comprehensive income would be reversed.

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

Given the change in the bank's circumstances related to capitalization and capital ratios, it could be argued that the bank no longer has the intent nor the ability to hold the securities until they could recover their losses. Without this intent or ability, the losses on the securities other than the seven securities sold would be viewed as other-than-temporary and yes, Generic Bank would have an impairment loss on the other securities at that time.

Case #5: A Tale of Two Cities

This case focused on one of the biggest decisions facing each us as we approach accounting recruiting season next semester. Where do you want to start your career? It would not be wise to go blindly into a new city without understanding the weather, industries, cost of living or modes of transportation most commonly used. I found the budgeting question very educational, as I had not investigated rental rates in Texas before. Even though both cities that I am interested in are in Texas, there are differences between the average rent, use of toll roads, utilities and in my assumptions of food and entertainment based upon how close to my family I will be living. This case allowed me to look at each city closer and consider things that I had not before now, making my decision easier and clearer.

1. **What is the population?**
   - **a.** Austin – 950,715
   - **b.** Houston – 2,312,717

Houston might be a little scary as large as it is and as unfamiliar as I am with the city.

2. **Describe the climate and seasonal fluctuations.**
   - **a.** Austin shares some characteristics of its two neighboring zones, the deserts of the Southwest and the green and humid lushness of the Southeast. Austin's climate is characterized by long, hot summers and short, mild winters, with warm spring and fall transitional periods. Austin averages around 34 inches of rainfall per year, distributed mostly evenly throughout the year, though spring and fall are the wettest seasons. Sunshine is abundant during all seasons, with 2,650 hours, or 60.3 percent of the possible total, of bright sunshine per year. January is the coldest month of the year, with normal highs in the low 60s and normal lows in the low 40s. Sub-

freezing temperatures occur on average about 19 days per year. Summers in Austin are long and hot. Normal highs reach 90 degrees by the end of May and remain above 90 degrees until the middle of September.

b. Houston has a humid subtropical climate. August normally ranks as the warmest month at 84.6 degrees and January the coldest month at 53.1 degrees. Houston, Texas gets 51 inches of rain, on average, per year. The US average is 39 inches of rain per year. Houston does not normally get any snow. Occasional severe weather mostly takes the form of flooding and hurricanes. Houston, Texas gets 51 inches of rain, on average, per year.

I believe that I would enjoy the weather in both cities, so this would not be a deciding factor in my decision.

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

a. Austin - Austin lies at the foot of the Balcones Escarpment, which is on the Colorado River and had three artificial lakes within city limits: Lady Bird Lake, Lake Austin, and Lake Walter E. Long. Austin's elevation ranges from 425 feet to approximately 1,000 feet above sea level. Much of the eastern part of the city is flat whereas the western suburbs consist of "rolling hills on the edge of the Texas Hill Country". However, compared to Houston, Austin is not flat by any means. Austin has several scenic areas such as Town Lake, Texas State Capitol, University of Texas campus and the 360 Overlook.

b. Houston – Houston is located on the gulf coastal plain. Downtown stands about 50 feet above sea level. There are major bayous passing through the city so water is a large geological feature and flooding is a constant concern. You can also drive to the Gulf of Mexico in about an hour for beach and boating activities.

The proximity to the beach in Houston is a strong draw, but the hills of Austin are so lovely that it would be hard for Houston to be more attractive than Austin to me.

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

   a. Austin – Texas has no state or local income tax, so the federal income tax is the only income tax. Property taxes are high in Austin, which drive apartment rental costs high also. Sales tax in Austin is 8.25 percent

   b. Houston – Texas has no state or local income tax, so the federal income tax is the only income tax. Property taxes are high in Houston, which drive apartment rental costs high also. Sales tax in Houston is 8.25 percent

Austin and Houston are basically the same from a tax perspective so this would not be a deciding factor. If I had $50,000 of taxable income, I would pay federal income tax of 10 percent on the first $9,525 and 12 percent on the income between $9,526 and $38,700. I would then pay 22 percent on the rest, because some of my $50,000 of taxable income would fall into the 22 percent tax bracket. My total federal income tax bill would be about $6,900 — about 14 percent of my taxable income, even though I would be considered in the 22 percent bracket. I could decrease that rate to 12.5 percent by contributing 6 percent

of my pre-tax income to a 401k plan, which would decrease the amount of my taxable income in the 22 percent tax bracket.

5. What transportation hubs are in the city?

Both Austin and Houston are very vehicle based cities, where public transportation is not the main mode of transportation. The traffic in Austin is becoming a large problem, but the sheer size of Houston could make a commute very challenging if my client base is not near my apartment.

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

- **a.** Austin – The most prevalent industries in Austin are technology and defense, which is why Austin is nicknamed "Silicon Hills", but it is also an emerging hub for both pharmaceutical and biotechnology companies.
- **b.** Houston – Houston is home to many different businesses, including headquarters for almost two dozen Fortune 500 companies. The Houston economy is primarily based in energy, but has rapidly diversified into medical research, technology, and health care and professional services.

This could really be a deciding factor in my decision. The prevalence of the energy industry in Houston is not attractive to me. I feel that being focused on an industry that specific could limit future mobility.

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

Overall, the state of Texas ranks in the bottom 10 out of all 50 states when it comes to healthcare quality. The ranking was based upon health care cost, health care accessibility and health insurance costs. Texas has the highest percentage of uninsured residents in the country, which makes healthcare much more inaccessible. However, Texas does relatively

well in treating cancer proven by the low death rates. This may be related to the MD Anderson Cancer Center located in Houston, Texas. This world-renowned facility is ranked #1 for cancer care in the United States. Another well-known name in the Houston area is Memorial Hermann, which is the largest not-for-profit healthcare system in the state of Texas. Some of the best hospitals in Austin consist of the Seton Medical Center as well as St. David's Medical Center. Austin also has a new medical school created by a partnership between Dell and The University of Texas at Austin, which could improve the healthcare quality in Austin. Being that healthcare quality is currently quite poor in both cities, this does not affect my decision between Houston and Austin.

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

a. Austin – Austin is a safe place to live with below-average violent crime rates. Most of the crime that takes place in Austin are property crimes. A large percentage of the violent crime incidents are assault related and its murder rate is the lowest of the four biggest cities in Texas. The most dangerous areas in Austin consist of Congress Ave., Downtown, West Campus and East Austin.

b. Houston – In Houston, both violent and property crime rates are higher than the national rates. The most common types of crimes are Property, Violent and Quality of Life, in that order. Two of the most dangerous neighborhoods are located in Houston, Texas. These areas to avoid are the neighborhoods Third Ward and Sunnyside as they have high violent crime rates.

Based on crime alone, Austin is far more desirable than Houston. I believe that both my parents and I would feel much more comfortable with me living "alone" in Austin than in Houston.

9. **Based on where you see yourself living for the first three years, how much rent do you expect to pay? Back up this assertion with sample properties from each location (including pictures). Describe the square footage, amenities, need for a roommate, availability of parking, etc.**
   a. Austin – If I were to live in Austin, I would most likely live at home for the first 3-5 months to save up money. Afterwards, I can see myself living in The Residences at the Domain, which is only a quick 15-minute drive from home. I could afford a two-bedroom, two-bath 1,200 square foot apartment for $1,800 a month. This amount would be split between my roommate and myself, totaling only $900 a month. A sample floorplan of the one described is shown in Figure1.1 below. Situated in a large retail development, there are plenty of places to shop and eat. The Residences amenities include both a fitness center and a pool. While there is street parking available, I am more likely to pay for a reserved spot in the garage.
   b. Houston – The rent in Houston is a little pricier, but not by a significant amount. For comparison purposes, I chose an apartment complex around Rice University called The Village at West University. For $1,948 a month, you can get a two-bedroom, two-bath 1,200 square foot apartment (shown in Figure 1.2). With a roommate, monthly rent will only be $1,000 a month. Amenities include a fitness center, business center, swimming pool and club room.

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

a. Austin – Austin is an automobile-dependent city, with an estimated 73.5 percent of commuters driving alone to work, 9.6 percent for carpooling, 3.6 percent for riding transit, 2 percent for walking, and 1.5 percent for cycling. In Austin, the average commute time is 26 minutes. However, from personal experience I believe that my daily commute would take anywhere from 30-45 minutes. This would be somewhat dependent on the location of the client site.

b. Houston – Houston is considered an automobile-dependent city, with an estimated 77.2 percent of commuters driving alone to work in 2016. In 2016, another 11.4 percent of Houstonians carpooled to work, while 3.6 percent used public transit, 2.1 percent walked, and 0.5 percent bicycled. In Houston, the average commute time is 30 minutes, but would be highly dependent on the location of the client site as Houston is a larger metropolitan area with several business districts. Toll roads would also play into the time and cost of the commute.

11. Where will you do your grocery shopping?

I will shop for groceries at H-E-B for both Austin and Houston. It is the grocery store that I grew up going to and love!

12. How will you do your laundry?

I will do my laundry in the apartment that I will lease in either Austin or Houston.

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

a. Austin – Austin Stone (Church), Impact Austin (Women's collective giving organization), and Austin Pets Alive (a no-kill, rescue organization)

b. Houston – Lakewood Church, Communities in Schools of Houston, Houston Pets Alive

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

a. Austin – Music festivals such as Austin City Limits and South by Southwest, attending University of Texas football games, playing sports on the Great Lawn in Zilker Park (shown in Figure 1.3), listening to live music downtown, and attending Formula 1 and the Grand Prix at Circuit of the Americas.

b. Houston – Houston has six professional major league teams, which offer year-round entertainment, compared to Austin, which has zero. I personally would attend Houston Texans (NFL), Rockets (NBA) and Astros (MLB) games. The shopping scene in Houston is very popular with spots including the Galleria, Highland Village, Green Street, etc. Other attractions include the Houston Zoo as well as the Space Center.

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

a. Austin – N/A as it is my hometown.

b. Houston – 2 ½ to 3 hour drive back home – 1 tank of gas each way totaling 60 dollars.

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

Year 2 - monthly budget	Austin	Houston
Base salary	$4,167	$4,167
Bonus	$833	$833
Less 401k EE contribution	($250)	($250)
Less Healthcare/benefits	($140)	($140)
Less taxes withheld	($710)	($710)
Rent (with roommate)	($1,200)	($1,100)
Utilities (with roommate)	($165)	($150)
Gas, tolls, parking	($200)	($240)
Gym membership or classes	($100)	($100)
Mobile phone	($140)	($140)
Travel	($150)	($150)
Food and Entertainment	($600)	($700)
Clothing	($200)	($200)
Left for additional savings	$1,145	$1,120

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

Yes, I am still interested in both Austin and Houston. Austin remains my preferred city, as it is my hometown and I have friends and family there, but the career opportunities and the strength of the big four accounting firms in Houston will keep Houston in the running.

The Residences at the Domain Sample Floorplan

Figure 1.1

Village at West University Sample Floorplan

Figure 1.2

Zilker Park

Figure 1.3

Case #6: WorldCom, Inc.

This case focused on the WorldCom accounting scandal revealed in 2002. An internal auditor at WorldCom found some unorthodox journal entries with a big impact. My thoughts after reading the *Wall Street Journal* article focused on three main themes:

1. How, in my future role as internal or external auditor, I would handle a similar situation. If the CFO of a large company, a significant client to my public accounting firm, pushed back on a question or finding, how would I stand my ground? In the early years of my career, I believe that I would find all the evidence and support that I can and would escalate an issue like this to my supervisors.
2. I found it important to note that these improper entries were not discovered by the external, public, accounting firm as the year-end audit for 2001 had been completed, but were discovered and revealed based on internal WorldCom work. With data analytics and fluctuation analysis taking a leading role in how to perform an efficient audit, I need to remember that some old-fashioned transaction testing can add value to an audit also.
3. At my summer accounting internship, I learned about Sarbanes Oxley controls in place at the company and journal entries required approval by someone other than the person proposing or entering the journal entry. That leads me to believe that the CFO of WorldCom was certainly not alone in the improper accounting acts, but was able to use his power, experience and position to influence others at WorldCom to look the other way or agree with his positions.

I found the case study interesting as a story, but the questions that it raised in my mind about how I would handle situations like this are important. I can see why the

Certified Public Accounting license has an ethics component to its continuing education requirement…to ensure that accountants are prepared for these difficult situations.

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

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

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

The FASB Statement of Concepts defines assets as items controlled by the company that will provide the company future economic benefits. An expense is a cost incurred by an entity in order to generate revenue. Costs should be expensed as they are used up from the company's operations. If costs will provide future economic benefit outside of the current operating cycle, that is when they should be capitalized as assets.

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.

Costs, after being capitalized, cease being a current period expense and become a fixed asset that is depreciated or amortized over the period of time that the asset will provide benefit. The decision to capitalize or expense depends on management. When the decision is made to capitalize an asset, the assets are increased on the balance sheet. The cost of the asset does not impact the income statement until the depreciation or amortization begins, at which time it decreases net income. Therefore, this decision affects the company's balance sheet, income statement and cash flow statement.

c. Refer to WorldCom's statement of operations. What did the company report as line costs for the year ended December 31, 2001? Prepare the journal entry to record these transactions for the year. Explain in your own words, what these "line costs" are.

WorldCom recorded $14.739 billion as line costs for the year ended December 31, 2001. The journal entry to record these transactions for the year would be:

Line Costs – Operating Expense	14,739,000,000	
Accounts Payable or Cash		14,739,000,000

To record the accrual of line costs.

Line costs represent what WorldCom was charged by local phone networks to use their networks to complete calls. These charges should be current period expenses as they are directly related to ongoing, current activities and do not benefit future periods.

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 definitive of assets of assets in part a above?

Line costs represent amounts paid under contracts with local phone networks for the right to use their networks to complete calls. The local phone networks charged WorldCom for access to the phone lines the local networks own and for transmitting that call over the same lines. An example of a typical transaction that gives rise to these costs and the need for WorldCom to contract with the local phone networks is a college student from Ole Miss calling her parents' home phone line in Texas. WorldCom is charging the

college student for the phone plan, but does not own the lines nor the rights to access the lines in Texas that are owned by AT&T. AT&T has spent years and billions of dollars putting up phone poles, lines, cables and terminals and contracts to allow other companies to use all of these assets. Although not stated in the *Wall Street Journal* article, I am assuming that these contracts were based upon a period of time (i.e. five-year contracts) and that the expense of the contracts was being spread evenly over the length of the contracts. Based upon the *Wall Street Journal* article, it appears that WorldCom contracted for more capacity from these local networks than they needed. When the revenue did not occur, but the costs per the local network contracts remained, Mr. Sullivan decided to spread the costs into the future in the hopes that the expected revenue would show up later. He improperly capitalized costs related to the current period's portion of the contracts with the local phone networks. These period costs related to the current period's portion of the contracts do not meet the definition of an asset, and therefore should have been expensed.

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?

The journal entry to improperly capitalize line costs would have been:

	Debit	Credit
Property, Plant and Equipment	3,055,000,000	
Line Costs – Operating Expense		3,055,000,000

To record the capital asset investment.

On the balance sheet, the costs appeared as an increase to the asset "Transmission Equipment" which is a part of PPE. On the statement of cash flows, the costs appeared as part of capital expenditures under cash flows from investing activities and the related

depreciation was included in depreciation expense under cash flows from operating activities.

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.

Given that the midpoint of the estimated useful life range for transmission equipment would be 22 years, the depreciation expense related to these improperly capitalized costs would be $83,306,818.

Calculation of related depreciation for 2001:						
	Amount	Life in Years	Life in Quarters	Depr expense/Qtr	Qtrs of expense in 2001	Depr exp
Q1'2001 capex	$ 771,000,000	22	88	$ 8,761,364	4	$35,045,455
Q2'2001 capex	$ 610,000,000	22	88	$ 6,931,818	3	$20,795,455
Q3'2001 capex	$ 743,000,000	22	88	$ 8,443,182	2	$16,886,364
Q4'2001 capex	$ 931,000,000	22	88	$10,579,545	1	$10,579,545
				2001 Total		$83,306,818

The journal entry recording the depreciation expense for these improperly capitalized assets would be:

Depreciation Expense 83,306,818

Accumulated Depreciation – Transmission Equip. 83,306,818

To record depreciation expense.

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

A company that capitalizes costs is expected to have a higher profitability in the early years than it would have had it expensed the costs, so I expected to see net income decrease. I assumed that WorldCom could benefit from a tax loss at the same marginal tax rate (35%). Based upon the below table I prepared showing the corrections and their impact, I believe that the difference is material. The improper capitalization masked a flip from net income to net loss, which is a significant quantitative difference. In addition, the corrections almost wiped out operating income, which is a key performance indicator tracked by analysts and investors. I believe the market and the accounting world found the corrections to be material also.

	2001 (uncorrected)	Corrections	2001 (corrected)
Revenues	$ 35,179		$ 35,179
Operating Expenses:			
Line costs	14,739	3,055	$ 17,794
Selling, general and administrative	11,046		$ 11,046
Depreciation and amortization	5,880	(83)	$ 5,797
Other charges	-		
Total	31,665		34,637
Operating income	3,514		542
Other income (expense)			
Interest expense	(1,533)		$ (1,533)
Miscellaneous	412		$ 412
Income before income taxes, minority interests and cumulative effect of accounting change	2,393		(579)
Provision for income taxes	927		(203)
Income before minority interests and cumulative effect of accounting change	1,466		(376)
Minority interests	35		$ 35
Net income	1,501		(341)

Case #7: Starbucks Corporation

This case study focused on Starbucks Corporation and the analysis and interpretation of its financial statements. The first half of the case was spent researching Starbucks Corporation and learning more about its operations and how they report their financial statements. After having done that, we could better understand and evaluate the common-size income statements and balance sheets for the years 2012 and 2013. We picked each of these statements apart and focused on certain sections more closely. I believe this is somewhat similar to what auditors do in their regular workdays. I found this case challenging yet interesting as I learned more about Starbucks Corporation and all the work that goes behind evaluating financial statements.

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 in the business of producing and selling handcrafted coffee and tea beverages along with fresh food items throughout their retail stores. Starbucks also sells several of their trademark items throughout other retail channels such as grocery stores, foodservice accounts, etc. Starbucks makes money by marketing and providing a high-quality coffee experience and charging a high price point for their products.

Starbucks has four operating segments: The Americas, consisting of the US, Canada, and Latin America; Europe, Middle East, and Africa (EMEA); China /Asia Pacific (CAP); Channel Development.

Starbucks opened its first store in Seattle, Washington in 1971, selling only roasted coffee beans. As of 2018, there are 28,218 locations worldwide, employing over 238,000 employees and selling much more than just roasted coffee beans.

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

The financial statements commonly prepared for external reporting purposes are the Income Statement, Balance Sheet, Statement of Cash Flows, and Statement of Stockholders' Equity. Starbucks refers to these financial statements as Consolidated Statement of Earnings, Consolidated Balance Sheets, Consolidated Statements of Cash Flows, and Consolidated Statements of Equity. "Consolidated" financial statements are the combined statements of the parent company along with its wholly owned subsidiaries and investees. In this case, the parent company being Starbucks and the subsidiaries Teavana, Seattle's Best Coffee, Tazo, Evolution Fresh, etc.

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

Publicly traded companies are responsible for periodically updating creditors, investors, lenders, customers, etc. on the financial condition of the company. Unlike private companies, public companies are regulated and monitored by the Securities and Exchange Commission which controls how and when the company must issue its financial statements. According to SEC rules, companies must file financial statements at the end of every quarter. Starbucks is not a calendar year-end company, but instead has their year-end on the Sunday closest to September 30 each year. Therefore, they file their 10-K as of the end of September and their 10-Q's for the quarters ended December, March and June.

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

interested in.

A company's management is responsible for preparing the company's financial statements and related disclosures. The Chief Executive Officer (CEO) and Chief Financial Officer (CFO), acting as the principal financial officer, is then responsible for signing the financial statements as the to ensure their accuracy and reliability. The CEO and CFO also sign quarterly certifications attesting that the company's internal controls have been designed to ensure all material information is disclosed, that the controls have been evaluated to ensure that they are operating effectively and that the 10-K and 10-Q's present, the financial condition and result of operations of the company.

Potential users of Starbucks financial statements may include: company management, analysts, competitors, customers, employees, investors, lenders, etc. Company management will be interested in the profitability, liquidity, and cash flows of the company in order to make decisions regarding the operation of the business. Analysts will use the information to update their analyst reports quarterly for their investors and advise on buy, sell or hold recommendations for Starbuck stock. Competitors may use the information from the financial statements to evaluate its financial condition and gain a competitive advantage. Customers want to ensure that the company will remain in business long enough to fulfill the terms of their contract. Employees should have basic knowledge and understanding of the business and its financials. Investors will want to monitor the performance of their investment. Creditors will require financial statements to ensure the borrower is able to pay back all of its obligations.

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?**

The Seattle office of Deloitte & Touche LLP (Deloitte) is the firm that performs the external audit of Starbucks. The first opinion is on the financial statements as listed above. In this opinion, Deloitte explains that in their opinion, based upon their audit work and testing, the financial statements are materially correct and in accordance with U.S. GAAP. The second opinion is related to Starbucks internal controls over financial reporting. In this opinion, Deloitte states that they believe the company has designed adequate controls and that these controls are operating effectively enough to prevent material errors or misstatements in the financial statements.

Both opinions were issued on November 18, 2013. The weeks between the September 29, 2013 year-end and November 18, 2013 allow the company time to close their books and prepare their annual tax provision. Once the books are closed, Deloitte is allowed time to bring in teams of audit and tax experts to continue the interim and test of control work that they have been performing all year and update their testing to include the year-end balances. Without this time, Deloitte could not be confident that errors had not occurred in the last quarter of the year.

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).

Starbucks Corporation
Consolidated Balance Sheets (USD $)
For the Years 2012 and 2013

	Sep. 29, 2013		Sep. 30, 2012	
	Amount in Millions	**% of Assets**	**Amount in Millions**	**% of Assets**
Current assets:				
Cash and cash equivalents	$2,575.70	22.36%	$1,188.60	14.46%
Short-term investments	658.1	5.71%	848.4	10.32%
Accounts receivable, net	561.4	4.87%	485.9	5.91%
Inventories	1,111.20	9.65%	1,241.50	15.10%
Prepaid expenses and other current assets	287.7	2.50%	196.5	2.39%
Deferred income taxes, net	277.3	2.41%	238.7	2.90%
Total current assets	5,471.40	47.51%	4,199.60	51.09%
Long-term investments	58.3	0.51%	116	1.41%
Equity and cost investments	496.5	4.31%	459.9	5.60%
Property, plant and equipment, net	3,200.50	27.79%	2,658.90	32.35%
Deferred income taxes, net	967	8.40%	97.3	1.18%
Other assets	185.3	1.61%	144.7	1.76%
Other intangible assets	274.8	2.39%	143.7	1.75%
Goodwill	862.9	7.49%	399.1	4.86%
TOTAL ASSETS	11,516.70	100.00%	8,219.20	100.00%
Current liabilities:				
Accounts payable	491.7	4.27%	398.1	4.84%
Accrued litigation charge	2,784.10	24.17%	0	0.00%
Accrued liabilities	1,269.30	11.02%	1,133.80	13.79%
Insurance reserves	178.5	1.55%	167.7	2.04%
Deferred revenue	653.7	5.68%	510.2	6.21%
Total current liabilities	5,377.30	46.69%	2,209.80	26.89%
Long-term debt	1,299.40	11.28%	549.6	6.69%
Other long-term liabilities	357.7	3.11%	345.3	4.20%
Total liabilities	7,034.40	61.08%	3,104.70	37.77%
Shareholders' equity:				
Common stock ($0.001 par value) - authorized, 1,200.0 shares; issued and outstanding, 753.2 and 749.3 shares (includes 3.4 common stock units), respectively	0.8	0.01%	0.7	0.01%
Additional paid-in capital	282.1	2.45%	39.4	0.48%
Retained earnings	4,130.30	35.86%	5,046.20	61.40%
Accumulated other comprehensive income	67	0.58%	22.7	0.28%
Total shareholders' equity	4,480.20	38.90%	5,109	62.16%
Noncontrolling interests	2.1	0.02%	5.5	0.07%
Total equity	4,482.30	38.92%	5,114.50	62.23%
TOTAL LIABILITIES AND EQUITY	$11,516.70	100.00%	$8,219.20	100.00%

Starbucks Corporation
Consolidated Statements Of Earnings (USD $)
For the Years 2012 and 2013

	12 Months Ended			
	Sep. 29, 2013		Sep. 30, 2012	
	Amount in Millions	% of Sales	Amount in Millions	% of Sales
Net revenues:	$11,793.20	79.19%	$10,534.50	79.21%
Company-operated stores	1,360.50	9.14%	1,210.30	9.10%
Licensed stores	1,738.50	11.67%	1,554.70	11.69%
CPG, foodservice and other	14,892.20	100.00%	13,299.50	100.00%
Total net revenues	6,382.30	42.86%	5,813.30	43.71%
Cost of sales including occupancy costs	4,286.10	28.78%	3,918.10	29.46%
Store operating expenses	457.2	3.07%	429.9	3.23%
Other operating expenses	621.4	4.17%	550.3	4.14%
Depreciation and amortization expenses	937.9	6.30%	801.2	6.02%
General and administrative expenses	2,784.10	18.70%	0	0.00%
Litigation charge	15,469	103.87%	11,512.80	86.57%
Total operating expenses	0	0.00%	0	0.00%
Gain on sale of properties	251.4	1.69%	210.7	1.58%
Income from equity investees	-325.4	-2.19%	1,997.40	15.02%
Operating income	123.6	0.83%	94.4	0.71%
Interest income and other, net	-28.1	-0.19%	-32.7	-0.25%
Interest expense	-229.9	-1.54%	2,059.10	15.48%
Earnings before income taxes	-238.7	-1.60%	674.4	5.07%
Income taxes	8.8	0.06%	1,384.70	10.41%
Net earnings including noncontrolling interests	0.5	0.00%	0.9	0.01%
Net earnings attributable to noncontrolling interest	$8.30	0.06%	$1,383.80	10.40%
Net earnings attributable to Starbucks	$0.01	0.00%	$1.83	0.01%
Earnings per share - basic	$0.01	0.00%	$1.79	0.01%
Earnings per share - diluted				
Weighted average shares outstanding:	749.3		754.4	
Basic	762.3		773	
Diluted	$0.89		$0.72	
Cash dividends declared per share				

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

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

$11,516.70 = $7,034.40 + $4,482.30

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

such as Starbucks?

Starbucks' major assets according to the Balance Sheet are Cash and Cash Equivalents, Inventories, and Property, Plant and Equipment.

Proportion of Short-Term Assets to Total Assets: $5,471.40 / $11,516.70 = 47.51 percent

Proportion of Long-Term Assets to Total Assets: $6,045.30 / $11,516.70 = 52.49 percent

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

Generally, intangible assets are assets that lack physical substance, but are considered valuable resources of the business. Goodwill represent the excess of the cost over the fair value of assets acquired in a business acquisition. Intangible assets are fair valued as of the date of acquisition, usually by a valuation specialist and represent the non-tangible assets acquired in a business acquisition. Specific intangible assets that Starbucks might have are trade secrets, licensing agreements, acquired rights, trade names, trademarks contract-based patents and copyrights. Starbucks may also have patents that gives them the exclusive right to make and sell their products.

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

Starbucks is financed by both debt and equity. Starbucks issued long-term debt of $749.7 million in 2013, as noted in the Consolidated Statements of Cash Flows. This added to $549.6 million of long-term debt as of the previous year-end, bringing total long-term debt to $1,299.4 million as of September 29, 2013. Comparing this to the $4.4 billion in shareholders' equity as of the same date, gives

us a proportion of 29 percent of total financing coming from non-owners.

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?

Company-operated stores revenues are recognized when payment is offered at the point of sale, net of taxes collected and remitted to taxing authorities. Licensed stores revenues related to products are generally recognized upon shipment, but that is dependent on the shipping and contract terms. Starbucks records revenue on stored value cards when the cards are redeemed or when it appears likely, based upon historical expense, that it will never been redeemed (i.e. a percentage that are lost or only have a few cents left on them so are thrown away by customer). The fact that there are no expiration dates on the stored value cards and no service fees degrade the customer balances over time, means there are old cards in existence with balances on them. The estimates of what percentage of the outstanding balances on the cards will never be redeemed could vary by country or

region or by how the balances are carried. For example, balances carried in an app might be more likely to be used versus on a physical card that could be misplaced.

ii. What are Starbucks' major expenses?

Based on the Consolidated Statements of Earnings for both 2012 and 2013, Cost of sales including occupancy costs and Store operating expenses are Starbucks' major expenses. Cost of sales including occupancy costs as a percent of sales is 43.71 percent in 2012 and 42.86 percent in 2013. Store operating expenses are 29.46 percent (2012) and 28.78 percent (2013) respectively.

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

Other than additional long-term debt there were not significant changes to the cost structure, but effective at the beginning of fiscal 2012, Starbucks implemented a strategic realignment of our organizational structure designed to accelerate their global growth strategy. In connection with those changes, they changed how certain indirect overhead costs were reported. Certain indirect merchandising, manufacturing costs and back-office shared service costs, which were previously allocated to segment level costs of sales and operating expenses, are now managed at a corporate level and are reported within unallocated corporate expenses. These expenses have therefore been removed from the segment level financial results. The overall increase in operating expenses may also be accredited to the litigation charge in the year 2013.

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?

Arbitration concluded on litigation with Kraft Foods Global, Inc. on November 12, 2013, which resulted in a pretax charge to fiscal 2013 operating results of $2.8 billion. This charge reduced EPS by $2.25 per share in fiscal 2013. This litigation charge must be separately reported and disclosed in the financial statements and its notes for the year in which the charge was incurred, according to GAAP. Because the litigation charge was large enough to be included in the financial statements, it is material and significant in amount and therefore must be reported under "Operating Expenses".

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

Yes, although the large litigation charge hurt the profitability for 2013, there were still positive earnings per share for both 2013 and 2012. Removing that one-time litigation charge shows operating income growth from 2012 of $1,997.4 million to $2,458.70 million. I would define profitable as how the normal business of the company performs excluding one-time events. A further look at the Consolidated Statement of Cash Flows, show a positive trend in net cash provided by operating activities from $1.7 billion in 2012 to $2.9 billion in 2013.

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

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

The difference between net earnings of $8.8 million to net cash provided by

operating activities of $2,908 million is primarily due to the add back of the litigation charge into net cash provided by operating activities. Although, the litigation charge is partially offset by an increase in the deferred income tax asset.

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

Investment in Property, Plant and Equipment has increased from $2,658 million in 2012 to $3,200 million in 2013. In addition, according to the Consolidated Statement of Cash Flows, Starbucks had additions to property, plant and equipment of $1,152.20 million in 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?**

According to the Consolidated Statements of Cash Flows, Starbucks had cash dividend paid of $628.9 million during the year ended September 29, 2013. This amount is lower than the number of dividends declared of $668.6 million shown in the Statement of Stockholder's Equity, which would result from a $39.7 million larger amount of dividends payable existing at September 29, 2013 than existed at September 30, 2012.

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?**

Estimates are approximate numbers used throughout the financial statements. These approximate amounts are included when the numbers are not readily available or

attainable. The estimates usually involve subjective judgment and expertise and may require revisions and re-estimation in the future. The following accounts on Starbucks' balance sheet require estimates:

1. Short-term investments – discount rates are estimated
2. Accounts receivable, net – allowance for doubtful accounts is estimated
3. Inventories – excess and obsolete inventory estimated
4. Deferred income taxes, net – timing and amount of temporary difference and when turn
5. Long-term investments – discount rates are estimated
6. Property, plant and equipment, net – estimates of useful life and residual values
7. Other intangible assets – estimated fair value at date of acquisition
8. Goodwill – estimate of any impairment
9. Accrued litigation charge – estimates based upon legal representation
10. Accrued liabilities – estimates of bonuses and commissions to be paid out
11. Insurance reserves – estimate of self-insurance reserves needed based upon historical experience

Accounts that potentially could be estimate-free on Starbucks' balance sheet include:

1. Cash and cash equivalents
2. Prepaid expenses and other current assets
3. Accounts payable
4. Deferred revenue
5. Long-term debt

Case #8: BP p.l.c – Contingencies

This case study focused on BP and the contingent liabilities related to lawsuits associated with the Deepwater Horizon oil spill. The case gave me a better understanding of how challenging it can be to estimate future payments for natural disasters or catastrophic events. In order for a company to accrue any liability for a claim or lawsuit, it must be both probable and the charges able to be estimated, which can be a high threshold for companies to meet.

As lawsuits for disasters such as the Deepwater Horizon spill and Exxon Valdez oil spill can drag on for upwards of 25 years, it is important to understand the process for estimating a loss, accruing and updating these accruals quarterly. Understanding all the repercussions of a catastrophe such as these and what that means for a company's financials would be a challenge to any accountant. I learned the importance of open communication between any company's internal and external counsel and the finance and accounting departments.

As I enter my public accounting internship next winter, I now understand why a legal letter from the attorneys is requested each quarter to support the accruals and disclosures made in the company's financial statements. I also understand how slight differences in wording, for example, the difference between probable and reasonably possible, can make a big difference in a company's income statement.

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 when the company is aware of a claim or potential claim

against them where they could have exposure. A company would record a contingent liability when their internal or external counsel advise them that it is probable the claim or potential claim would lead to them paying some amount of money and the amount is able to be estimated.

Contingent liabilities are probable, reasonably possible or remote and accountants rely upon the attorneys to differentiate between these different types. Probable contingent liabilities mean that a future event (i.e. payment) will likely occur. Determining an estimate of the future payment is another challenge for the attorneys, but is needed to book the contingent liability. If a company and its management believes that a loss is highly likely to occur, accountants will record a journal entry to report the liability on the balance sheet and a loss or expense on the income statement. A reasonably possible chance that a future payment will be made is less than probable, but more than remote. A claim that is reasonably possible may be disclosed, but a contingent liability does not have to be recorded. A remote chance that a future payment will be made requires neither disclosure nor that a contingent liability be recorded.

Real life examples of contingent liabilities include slips and falls for restaurants and grocery stores, brake failures for automobile companies, software automation issues for Boeing 737 Max 8 airplanes and medical malpractice for doctors among many others.

Companies do not record contingent gains, even when probable and estimable, until they occur and are certain. If a company records a gain before it is certain, then they could be recognizing revenue before it is 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?

As the purchaser of the product, BP's perspective is that the manufacturer guarantees the quality of their products. If a defect is found in the warranty period, they can either get it repaired or get a replacement part. BP might wish that the manufacturer would be liable for any indirect, incidental or consequential damages caused by the failure of their product, but those items, in addition to lost profits and third party claims are not covered by most limited warranties.

From the perspective of General Electric Oil and Gas, they are willing to provide their customers a guarantee that the product purchased will meet the product specifications and standards advertised and for a specified period be free of manufacturer defects. GE Oil and Gas's warranty represents a potential loss during the warranty period.

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?

Management will need to make judgments on if any of the contingent liabilities are probable and if the amount of losses can be estimated. An amount for expected warranty claims based upon historical experience will need to be reasonably estimated, so that the

company can accrue for expected future warranty expense at the time of the sale of the product.

A claim for damages resulting from the Deepwater Horizon oil spill differs from the limited liability warranty claim on a piece of equipment in that the warranty claim has a limit that can be claimed equal to the amount paid for the piece of equipment. Being that the Deepwater Horizon spill was an unexpected catastrophe, claims for damages would be out of the ordinary, hard to estimate and with unknown costs that could be very high. If BP looked to the Exxon Valdez oil spill to assist them with estimating the scope of the costs and lawsuits they should expect, they would find that approximately 38,000 plaintiffs filed lawsuits against Exxon, including a class-action lawsuit on top of what Exxon paid in restitution, fines and cleanup fees.

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

BP's income statement for the first nine months in 2010 reflected a pre-tax charge of approximately $40 billion related to the oil spill. This charge consists of costs incurred up to date, future costs that could be estimated reliably at that time and $20 billion placed in escrow to settle lawsuits. When developing these estimates, BP appears to have used the settlements that Exxon made with all the plaintiffs who filed against them, including the State of Alaska and the United States government. Considering that it took over 25 years for all the Exxon criminal and civil lawsuits to settle, it would be safe to say that BP had a large amount of unknown and unrecorded future expenses in 2010. BP disclosed in its footnotes, "the total amounts that will ultimately be paid by BP in relation to all obligations

relating to the incident are subject to significant uncertainty."

Some of the additional estimates BP had to make as information became available related to legal costs, ongoing response, remediation and assessment efforts, fines, penalties, finance costs and any costs arising from any longer-term environmental consequences of the oil spill. These estimates were revised each quarter as more information was known and as the amounts the attorneys named probable and estimable grew over the years. According to BP's most recently filed 2018 annual report, since the oil spill, the total related pre-tax charges amount to $67 billion. Some of the largest charges included $42.4 billion of litigation and claims costs, $14.3 billion of spill response costs and $8.5 billion of environmental costs.

The $42.4 billion of litigation and claims costs related to the many kinds of lawsuits filed related to the BP oil spill. These included businesses seeking repayment for lost profits, businesses and individuals claiming property damage, wrongful death claims by the families of the 11 workers killed in the explosion, BP's own shareholders for loss in the value of the BP stock, environmental damage lawsuits and numerous lawsuits related to health problems and health risks. Given that the BP spill may have irreparably damaged fishing, tourism, health, wildlife and employment in the region, it is not surprising that BP continues to incur costs, update their disclosures each quarter and continues to accrue for future costs related to the spill.

Case #9: Wendy’s Company – Equity Method Investments

This assignment taught me about the reasons that companies invest in joint ventures. I also learned that the accounting for equity investments, including joint ventures, has evolved over time with the accounting guidance and the SEC's positions shifting to align more with how business acquisitions are handled, using the fair value approach. While accounting for joint ventures is aligned with the accounting for equity investments, there are unique conditions for joint ventures. This assignment demonstrated to me that staying current with the ever-changing accounting principles will be very important in my future career.

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

Companies may enter into joint-venture agreements for various reasons. These include expanding to new markets, getting to these new markets quicker than the company would be able to alone, managing risk, reducing the financial impact by sharing costs associated with marketing and product development, developing an innovative product that is more competitive, and combining different strengths. For example, if a rich, established company has built a great, long-standing reputation in a region, but has fallen behind in the area technology, a joint venture with a start-up company with innovative technology could be a wonderful way to modernize and the start-up could have access to financial resources they did not have before.

While the above are some of the big picture reasons, joint ventures can also be formed for access to a key supplier, to diversify product offerings, or to acquire the right to use a strategic asset. No matter the reason, companies that enter into joint ventures are hoping for a gain of some sort for their company and have decided that a joint venture is the best strategic move.

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.

As Wendy's has a 50 percent share in the partnership with Tim Hortons Inc. and is therefore able to exercise significant influence over the joint venture, the investment is viewed as an equity investment and follows the equity method of accounting. Historically, if the assets contributed to form a joint venture meet the definition of a business, there have been two general approaches a joint venture might consider when recognizing those assets: (1) a fair value approach or (2) a carryover basis approach. The SEC's views of how an investor in a joint venture should initially recognize its equity interest in a joint venture have evolved over time from applying the carryover basis to the contributed assets to using fair value. The SEC's willingness to accept fair value in more circumstances may have been driven by a desire to see more symmetry by reducing basis differences between the investors in a joint venture and the joint venture itself, in addition to providing transparent and useful information to investors.

Current practice indicates that an investor in a joint venture initially recognizes an equity interest in the joint venture that meets the definition of a business at fair value when all the following conditions are met:

- The new entity meets the definition of a joint venture,
- The investors in the joint venture are not related parties, and
- Fair value is reasonably determinable.

Any differences between what the investor put into it and equity in net assets of the joint

venture at the date of investment should be identified and accounted for as if the investee were a consolidated subsidiary. To the extent that this difference represents goodwill, it is not amortized.

Under the equity method of accounting, Wendy's results of operations include their share of the income or loss of the joint venture. After initial measurement, the joint venture investment on Wendy's books is adjusted subsequently to recognize Wendy's share of the earnings, losses and/or changes in capital of the joint venture after the date of acquisition. Dividends received generally reduce the carrying amount of the investment. In addition, equity method investments are assessed for other-than-temporary impairment at least annually, but more often if there is a triggering event or change in circumstances.

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?

When a company purchases part ownership in another company, the amount that they invested, or the value of the consideration that they transferred for that ownership is known. The assets, and liabilities, if any, they transferred become the net assets in the joint venture resulting in the equity of the joint venture. Using the fair value approach to determine the fair value of the identifiable net assets in the joint venture results in something similar to a purchase price allocation completed for the acquisition of a business. The fair value approach calculates the amount they received in exchange for their investment and often results in their share of book value recorded for the investee being lower than the amount they invested. The amount that the investment amount exceeds their

share of the book value of the underlying net assets of the investee is accounted for as goodwill. This is a common occurrence as the investors are willing to pay more for the investment as they believe in the investment or joint venture, have confidence that the investment is the best strategic move and hope for future gains.

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 included their current share of the two equity method investments on the investment line on the balance sheet. They included $89,370 and $91,742 for their equity investment in the joint venture with Tim Horton Inc. for the year ended 2012 and 2011, respectively. They included ($1,750) and $77 for their equity investment in the joint venture in Japan for the year ended 2012 and 2011, respectively.

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

Wendy's 50 percent share of TimWen's partners' equity at December 31, 2012 is $35,282. Compared to the amount Wendy's has recorded as their investment in TimWen at December 31, 2012 of $89,370, there is a $54,088 difference. In footnote 8 of the 2012 10-K, Wendy's disclosed that the difference is primarily due to purchase price adjustments from the Wendy's merger. Tracing the difference back to the start of the difference in 2008, the 2008 10-K disclosed that the excess was "assumed" to have been allocated to net amortizable assets with an average life of 21.1 years. During the Wendy's merger, their

assets and liabilities were marked to fair value resulting in a higher carrying value of Wendy's investment in TimWen, which exceeded their 50 percent interest in the underlying equity of the joint venture as shown in the summary balance sheets of TimWen presented in footnote 8. Although it is not detailed, the disclosure of "net amortizable assets with an average life of 21.1 years" is not what I would have expected to see. I would have expected the excess to be goodwill and not amortizable, but more details are not disclosed.

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?

The equity in earnings from Tim Wen of $13,680 in 2012 and $13,505 in 2011 was included in "Other operating expense, net" on Wendy's consolidated statement of operations.

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

Equity Investment – Joint Venture with THI	13,680	
Equity in earnings of Joint Venture with THI		13,680

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

The amount of the amortization of the purchase price adjustment in 2012 was $3,129 based on the average original aggregate life of 21 years.

Equity Income 3,129

Equity Investment – Joint Venture with THI 3,129

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

The amount of dividends that Wendy's received in 2012 and 2011 was $15,274 and $14,942, respectively.

Cash 15,274

Equity Investment – Joint Venture with THI 15,274

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

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

The negative adjustment for "Equity in earnings in joint ventures, net" of $8,724 in 2012 was calculated as follows:

2012 Equity in earnings of joint venture THI	$13,680
2012 Equity in loss for Japan joint venture	(1.827)
2012 Amortization of purchase price adjustments	(3,129)
Negative adjustment for cash flows	$8,724

Equity in earnings in joint ventures is included in net income so a negative adjustment is made to arrive at net cash from Wendy's operating activities.

As the joint venture is an investment, its earnings are not included in Wendy's operating income on the statement of cash flows.

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.**

THI income before income taxes and net income for 2012 was $27,377. As 50 percent of that is to be allocated to Wendy's for their ownership percentage which results in $13,688. Although it is not disclosed, it appears that the difference between the $13,688 and the "Distributions received from joint venture" of $15,274 appears to be $1,586 of the foreign currency translation adjustment noted in footnote 8. As the joint venture in THI is a Canadian joint venture transacted in Canadian dollars, having a foreign current translation adjustment makes sense. Dividends received are added back to Wendy's operating income on the statement of cash flows as dividends received from an equity method investment are not recognized as revenue. Therefore, the dividends were not included in net income at the top of the cash flow statement and need to be added.

Case #10: Johnson & Johnson – Retirement Obligations

Pension accounting is complex and filled with estimates, made by both the company and its actuaries. I learned that keeping up with all the moving parts and truing up actual performance and experience to what was expected can swing a company's funded position from year to year. It appears to be a very complex field based upon Johnson & Johnson's required disclosures. In an earlier case study, I learned to follow what the attorneys say regarding if claims are probable or not. In this case study, I learned that the actuaries are who to listen to regarding pension plans, when reviewing the reasonableness of a company's assumptions and the trends in these assumptions. It will be interesting to see how many companies still have active pension plans in 10 years.

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?

In layman's terms, a defined benefit plan is where the employer commits to paying the employee a defined, set amount per month at retirement, usually based upon a formula involving the employee's years of service and salary earned. A defined contribution plan is where the employer commits to contributing a certain amount, often matching a portion of what the employee themselves contributes, to a benefit plan.

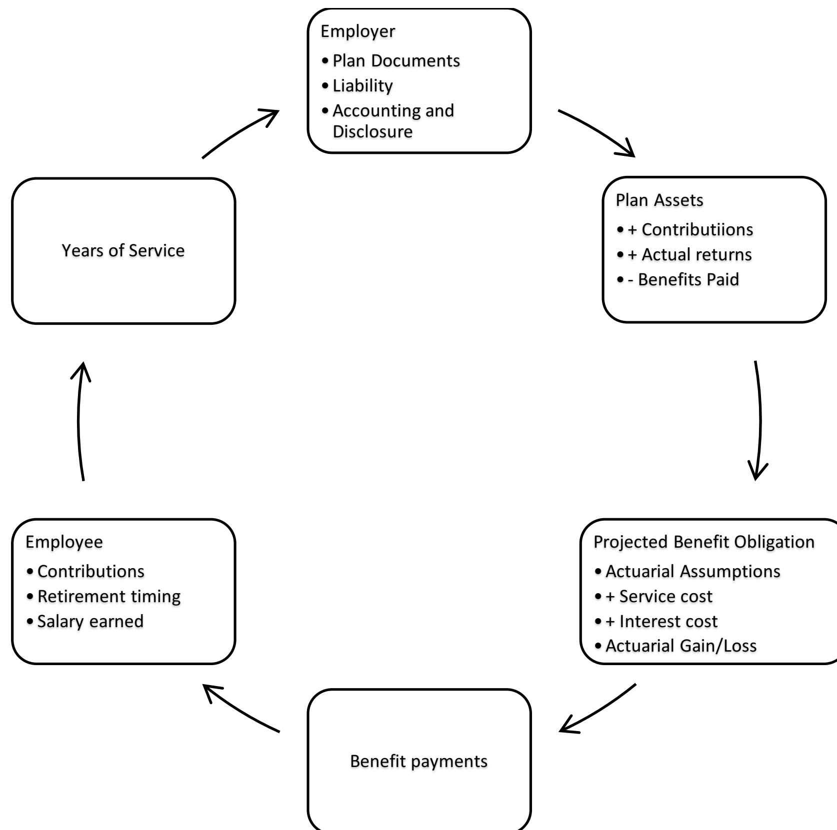
With a defined benefit plan, the company has long-term commitments and holds the risk that their investments will not get the expected rate of return needed to ensure that they can meet their future obligations to past employees. Economic downturns and changes in experience and actuarial projections can call for

increased employer contributions to keep the defined benefit plan funded at the appropriate level.

Johnson & Johnson has both defined benefit and defined contribution plans. Many companies that were founded long ago have changed the plans offered to new employees to defined contribution plans, but are still required to honor and fund the defined benefit plans of their past. Many of these companies have tried to either buy out prior employees with lump sum payment offers or purchasing annuity contracts from third-party insurance companies that would assume the responsibility for future benefits in an effort to decrease, de-risk or remove the pension liabilities on their balance sheets.

ii. Explain why retirement plan obligations are liabilities.

Retirement plan obligations represent promises employers have made to their employees about future retirement benefits that the employees will receive. They are based upon benefit plan documents filed with the Department of Labor's Employee Benefits Security Administration (EBSA). The EBSA administers the Employee Retirement Income Security Act of 1974 (ERISA), which governs retirement plans. Even if a company declares bankruptcy, the pension assets should not be at risk because ERISA requires that promised pension benefits be adequately funded and that pension monies be kept separate from an employer's business assets.



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

Some of the assumptions that a company must make and update each period to account for its retirement plan obligations include the expected rate of return on the plan assets, the rates at which the employee's compensation levels will increase, and the discount rate to calculate the present value of the benefit obligation. The employer also should disclose their best estimate of contributions expected to be paid to the plan during the next fiscal year. Companies usually engage actuaries who also estimate the number of years employees will work before retirement, the employee turnover rate and the number of years employees will receive pension benefits during retirement.

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

- Service cost related to a company's pension obligations means the increase in the pension obligation due to employees working another year at the company.
- Interest cost means the increase in the projected benefit obligation as interest accumulates during the current year on the outstanding amount. The interest rate used is referred to as the settlement rate because it is the rate at which the pensions could be effectively settled.
- Actuarial gains and losses represent changes in the actuarial assumptions based upon updated actual experience, changes in predictions of how long employees will work, live or collect benefits, or changes to pension benefits given employees under new arrangements or if a new benefit formula is adopted.
- Each year, the company must true up the benefits paid to retirees against what they projected would be paid during the year. This decreases the projected benefit obligation, because they are obligations that have already been paid. Assumptions around employee mortality rates and retirement dates might have produced different numbers than what was actually experienced.

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.**

- The actual return on pension investments refers to the actual gain or loss a company experiences on their plan investments. Companies often invest in insurance annuity plans in attempts to match their assumed future rate of return. Each year companies must record what they really receive from their investments compared to the projected future rate of return. Hopefully, the amount their pension investments made during the year did not fall short of their projections leaving them in danger of being underfunded.
- Each year companies contribute an amount of money to their plan to fund the liabilities that arose from that year of service by their employees. This amount is based upon their projections and estimates and the report from their actuary.
- Benefits paid to retirees decrease both the plan assets as well as the projected benefit obligations. An adjusting journal entry is not recorded on its balance sheet when these benefits are paid out to its employees.

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.

Pension plan assets often consist of stocks, bonds and other investment instruments such as insurance annuities and mutual funds. The return on plan assets represents the current year's earnings on invested plan assets. The formula used for computing actual return for pension plan assets is: Ending Balance (FV) – Beginning balance (FV) + Benefits – Contributions.

For pension expense, the actual return on plan assets is compared against the expected return on net assets and the if the actual return is lower than the expected return,

the there is a loss recorded in Other Comprehensive Income (OCI). If the actual return is higher than the expected return on net asset, there is a gain recorded in OCI. The actual return on plan assets is added to the plan assets during the year increasing the assets available.

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 the other-benefits plans and its retirement plans is that the company does not fund retiree health care benefits in advance and has the right to modify these plans in the future. The other-benefits plans are primarily focused around healthcare and are available to all U.S. retired employees and their dependents. Conversely, the retirement plans cover all employees worldwide.

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 recognized $646 million of pension expense in 2007 in its income statement. This number is the net of the service cost, interest cost, expected return on plan assets, amortization of prior service cost, recognized actuarial losses and other items as listed below.

Net periodic benefit costs for the Company's defined benefit retirement plans and other benefit plar

(Dollars in Millions)		2007
Service cost	$	597
Interest cost		656
Expected return on plan assets		(809)
Amortization of prior service cost		10
Amortization of net transition asset		1
Recognized actuarial losses		186
Curtailments and settlements		5
Net periodic benefit cost	**$**	**646**

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

Service and Interest Cost entries:

Pension Expense	597 million	
PBO		597 million
Pension Expense	656 million	
PBO		656 million

Also, the expected return entry is as follows:

Plan Assets	809 million	
Pension Expense		809 million

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

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

Johnson & Johnson's retirement plan obligation was $12,002 million as of December 31, 2007. This is an estimate of the future stream of benefit obligations

after discounting the stream to a single number representing the present value. Given the number of assumptions that need to be made by the company and it actuaries, this number is not reliable, but it will continue to be adjusted as estimates change each period.

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

The pension-related interest cost for 2007 was $656 million. The average interest rate is computed as $656 interest cost/$11,660 projected benefit obligation at the beginning of the year = 5.62 percent. Yes, this rate appears to be reasonable, if a little low, compared to the discount rate assumed for 2007 of 6.5 percent for the U.S. benefit plans and 5.50 percent for the international plans as disclosed on page 61.

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 benefits in 2007. Cash is paid to the retirees from the plan assets. Benefits paid decrease the retirement plan obligation and decrease the retirement plan assets as shown in the roll forwards of each of these on page 62.

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 the retirement plan assets held by Johnson & Johnson's retirement plan at December 31, 2007 is $10,469 million. This is the fair value of the equity and debt securities and other investments held by the plan at December 31, 2007.

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?**

Johnson & Johnson's expected return on plan assets for 2007 and 2006 was $809 million and $701 million, respectively. The 2007 actual returns of $743 million did not compare favorably to expected returns, showing an 8 percent shortfall when compared to expectations. In 2006, the actual returns were $966, over 37 percent greater than the expected return on plan assets for 2006.

According to page 61, Johnson & Johnson expected the returns on plan assets to be 9 percent for their U.S. benefit plans for both 2007 and 2006 and 8.25 percent and 8.0 percent for their international plans for 2007 and 2006, respectively. The actual 2007 and 2006 returns of $743 million and $966 million represent 7.7 percent and 11.9 percent of plan assets at fair value at the beginning of 2017 and 2016, respectively. According to page 61, Johnson & Johnson expected the returns on plan assets to be 9 percent for 2006 and 2007. In my opinion, the 2017 return better reflects the economics of the company's pension expense as the large return in 2006 was an anomaly. Accounting guidance requires companies to smooth out

anomalies or fluctuations in investment returns and actuarial assumptions so that pension fund accounts do not appear over-stated after one year of above average returns. This smoothing makes it difficult to get a clear picture of the real economics of the fund.

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

Johnson & Johnson contributed $317 million in 2007, a 22 percent increase over the $259 million the Company contributed in 2006. The employees contributed $62 million in 2007, a 32 percent increase over the $47 million they contributed in 2006.

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

Pension plan assets often consist of stocks, bonds and other investment instruments such as insurance annuities, mutual funds and real estate. Johnson & Johnson's retirement plan assets are invested primarily in equity securities, some debt securities and a very small amount in real estate and other investments.

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

The funded status of a retirement plan is shown by comparing its plan assets to see if they greater than its projected benefit obligation. Johnson & Johnson's pension plan is underfunded as of December 31, 2007 and 2006. Amounts related to the Company's

retirement plan are included in non-current assets, current liabilities and non-current liabilities on the balance sheet. Johnson & Johnson discloses in footnote 13 on page 63 that they were not required to fund their U.S. retirement plans in 2007 nor will they be required to fund them in 2008.

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

To date, I feel that I have spent my time in school learning the current accounting rules and how to account for transactions accurately. This case study was the first time that I really examined the conceptual framework and read about different foundational approaches and the differences between them. It made me realize that I will not only have to be educated on the current accounting guidance, but the interplay between the balance sheet and income statement.

The article's claim that "the volatility of reported earnings has doubled and the persistence of earnings is down by about a third" during the last 40 years concerns me, who at the start of my career, might see a lot of upheaval. Revisions to the accounting rules and guidance as to how a company's operating, investing and financing activities should be reported on the balance sheet, income statement and statement of cash flows might bring immense changes for firms and for the companies. It will certainly be an interesting career as I assist my clients in implementing the changes.

Columbia Business School's Center for Excellence in Accounting and Security Analysis (the "Center") argues that the concept of income is more useful than the balance sheet, but in the past 30 years, the FASB has transitioned the rules and guidance to the balance sheet approach. Examples are SFAS 96 and SFAS 109, which changed the income tax reporting from an income statement orientation to a balance sheet orientation, SFAS on hedging, SFAS 141 on acquisitions, intangibles and goodwill, and SFAS 150 on fair value accounting. More time is being spent by accounting departments developing estimates in order to comply with these new rules and guidance, when their time might be better spent improving on the accuracy of the results presented.

The Preliminary Views document issued by the FASB in 2006 appears to be a

strong indication that the FASB and IASB are re-considering the conceptual framework, but is still very obviously fixated on the balance sheet model. The Center establishes four compelling reasons for the FASB and IASB to re-consider the balance sheet-based model of financial reporting.

The first is that the balance sheet approach does not align with how most businesses are run. The main drive of for-profit companies is to make a profit and the money they spend is in the hopes that it will lead to future revenue. The Center argues that assets are not "greenhouses" where value is stored, but instead that assets are continuously transforming as they are used up, spent and earned through the earnings process. An example used was from the Italian trading guilds in the late Middle Ages. Individuals would partner together to fund the purchase of a ship, crew appointment and other expenses that came along with the venture. Once the trade was completed, the partners would divvy up the money, dissolve the partnership and sell off the assets. The ship and inventory were just temporary assets used to carry out the mission, but what really mattered was the revenues earned.

The second is that the income is a better foundation for financial reporting. FASB argues that asset-oriented accounting is preferred over income-oriented accounting because one cannot define earnings without first defining assets. However, this thinking is illogical because FASB then proceeds to define assets in terms of expected earnings. Assets and income are totally connected in the sense that if there is income, there must be some sort of asset producing it. As intangible assets become increasingly prominent, the concept of income is a clear choice. For example, when looking at Microsoft's financials, it is clear that the assets listed do not account for the company's exceptional profitability. The only

explanation is that there must be some missing assets to explain for these profits (intangibles or goodwill). Intangible assets pose a large practical problem as they are difficult to find and utilize in any way.

The third is that the balance sheet approach is to blame for the lack of predictability in earnings. Income and earnings are what the investors, analysts and top management care most about. In balance sheet accounting, every asset and liability is updated to its fair value each period. However, due to unpredictable changes in the market these values are volatile and less persistent. A large pickup in income or hit to expense due to an asset impairment, an income tax position, or a change in pension assumptions could cloud the view of how a company is truly performing as a business. Two particular sentences in the Center's article stood out to me. The Center stated that, "…the major beneficiary from good earnings is small and unsophisticated investors, who tend to use heuristics like price-to-earnings ratios to value investments" and "unsophisticated investors who continue to uncritically rely on earnings will increasingly feel like standing on shifting sand as the predictive power of earnings continue to erode." As the FASB emphasizes that the balance sheet is of the utmost importance, maintaining a rational and understandable earnings story and trend becomes harder and harder for companies.

For example, the increase in intangible assets, which often amortize over long periods of time and goodwill, which does not amortize at all, inflates balance sheets. When impairments of any of these assets hit, earnings can look horrible, but that does not accurately reflect how the company is actually doing. In addition, the focus on the balance sheet approach has de-emphasized the importance of the principal of matching expenses to revenue. Our last case study, which focused on pension accounting, demonstrates the sheer

number of estimates, for fair valuations, actuarial assumptions, liabilities, that are used throughout the balance sheet. Estimates are not actuals. Revenue, based on invoiced, delivered product, is a truer representation of the actual performance and future of a company. When revenue is appropriately matched with expenses, the balance sheet and the accruals necessary are secondary.

The fourth is that there are issues with applying that balance sheet-based model of accounting. Problems with applying "mark-to-market" accounting causes firms to resort to "mark-to-model" accounting, which became infamous after the Enron scandal. The "mark-to-model" approach is highly subjective which has the potential of large estimation errors and manipulation of numbers. Another problem is that balance-sheet accounting and mark-to-market and fair-value accounting create a cause and effect between the market and the real economy. It is important to keep valuation estimates and educated guesses about values out of financial reports.

Before dot.com startups, online banking, the spread of mobile phones and social media companies with large valuations, the FASB adopted the balance sheet-based model of financial reporting. The U.S. companies with the largest market capitalizations 30 years ago were Exxon, IBM and GE. All three were asset intensive companies with large balance sheets and stable revenue. Today, with Apple, Alphabet (Google), Amazon, Microsoft and Facebook topping the market capitalization list, the Center believes it is time for a change, and I agree. The article educated me and forced me to examine the foundations of the accounting and auditing.

When the Big four auditors came to the company where I was interning last summer, I noted that they had a materiality level that they had calculated guiding them on

fluctuations and balances to investigate and test. This article made me curious as to how the Big Four set these materiality thresholds.

The PCAOB's guidance states that the auditor should consider "the company's earnings and other relevant factors", while the ASB states "depending on the circumstances of the entity, include categories or reported income, such as profit before tax, total revenue, gross profit, and total expense; total equity; or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenue." Balance sheet benchmarks do not appear to be the focus of either the PCAOB or ASB's materiality guidance. That is another piece of evidence that while of course, everyone wants the balance sheets of companies to be correct, it is income and earnings that is the center of everyone's attention.

During my internship, the Controller asked me to draft the Company's memo on the implementation of the new lease standard. This felt like an ambitious assignment for an intern who had not even taken intermediate accounting, but thinking back, I remember that the lease standard had very little impact on that Company's income statement. It was purely a gross up of right-to-use assets and lease liabilities on the balance sheet. The CFO and Controller were not that concerned about the lease standard, as it was not going to impact income or earnings. Now that I read this article, I am beginning to understand what the Controller and the CFO themselves focused on and worried about and what they did not.

It is obvious that the standards put into place by the FASB are constantly being revised and changed and it is important to have a say in those changes. The FASB asks for

input and I know that the accounting firms respond to these requests. Staying educated about the direction the FASB is heading sounds like both a challenge and an imperative for people, like me, who hope to make a career in public accounting. Going into this industry, it is important to stay up to date with the changes being made by the FASB and how it will change financial reporting.

Big Four accounting firms spend a lot of time and money educating their staff so a public firm sounds like a great place to stay up-to-date. Various alternatives to our current model of financial reporting are being discussed and deliberated. As I am at just at the start of my career, I could easily be living with the FASB's current decisions for my entire career.

In addition to staying up to date, I have learned that it is important for auditors to stay independent and skeptical. It appears that many companies are motivated primarily by income and earnings results and that they downplay and often even remove balance sheet driven items that have impacts to earnings through non-GAAP reconciliations presented with their earnings releases.

In my future career, I will be more aware and watch for what could be earnings-based motivations whenever my clients decide that it is the right time to impair an asset, change an assumption or decide how to mark an asset to market. I have heard that when companies have acquisitions hat cloud how earnings are expected to look, they use that as an opportunity to clean up other unrelated items such as impairments in the same quarter/year as the changes will not be as noticeable. Also, when a quarter is already not looking favorable versus analyst expectations, that CEOs and CFOs are often tempted to time all sorts of bad news in that quarter in an effort to cloud the issues and to "take their

medicine" all at one time. Instead of a string of quarters with small pieces of bad news, they believe that pushing all the bad news into one quarter may minimize the impact on stock price as the analysts and markets only dig into the biggest and most easily understood parts.

As I progress further in public accounting, I will watch to ensure that the correct level of staff, senior or manager look at areas that could be subjective and have a large impact the income statement. I will also be sure to bring anything that I think is unusual up the notice of my managers as I learn to ensure that I do not miss anything that could be significant.

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

It was very interesting to see how the market responds to earnings releases, both from a timing and a stock movement perspective. It is apparent that analysts must have high expectations of Google as the market sometimes rewarded their revenue and earnings per share growth, and other times it did not (i.e. Q2'13).

As I traced the timing of Google's earnings releases and the market's responses, I realized that CEOs, CFOs and Investor Relations departments have a difficult job. They must present their company in the best light possible, but not mislead the investors and analysts at the same time. Every company wants investors and analysts to understand what numbers they expect to deliver and why, otherwise the stock price could take a hit. In addition, CEOs, CFOs and Investor Relations departments must follow fair disclosure rules and be cautious to not tell any analyst a piece of information that has not yet been shared with the public. Managing analysts' expectations and their models is very important to how the stock price reacts each earnings release.

I also learned about non-GAAP financial measures and pressure from the SEC to move away from reporting them. It is apparent that some non-GAAP financial measures are very useful to analysts and investors, but are not required by GAAP, the SEC or FASB. Many industries have specific key performance indicators that appear to be leading gauges on the company's future financial health. If the company has been reporting these for years and the investors and analysts are accustomed to being given that information, I doubt they will react well when that information is no longer provided.

After completing this case study, I now understand that I will encounter non-GAAP financial measures in my future career in public accounting. I now know what non-GAAP measures are and what purpose they have for companies and analysts, but will have to

discuss the need for the non-GAAP measures being presented and their prominence, to ensure that they are not given higher billing than GAAP measures, with my clients.

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

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

Google's non-GAAP net income is best described as net income excluding expenses related to stock-based compensation and other special items such as, merger and acquisition costs, restructuring charges, gains and losses on the sale of assets, etc. All non-GAAP financial measures, including non-GAAP net income, are meant to be a supplement rather than a substitute to the US GAAP measures. Non-GAAP measures may provide meaningful insight into the company's current and future performance by excluding expenditures that are not representative of the core business operations. Item 10(e) of Regulation S-K specifically prohibits the elimination of items that are recognized as "infrequent", "unusual" or "non-recurring" if there had been a similar charge in the past two years or is likely to occur again in the next two years. The adjustments Google chose to make between GAAP and non-GAAP measures was to eliminate stock-based compensation

expense, as well as restructuring and related charges. According to the PWC report that I mentioned above, the elimination of stock-based compensation expense is often done because it is non-cash and often seen to be less relevant for investors when assessing the operating results of a company. These differences caused a $682 million adjustment in net income in the year 2012 and a $720 million difference in 2013. Stock-based compensation (SBC) is a non-cash charge that will continue to be a significant recurring expense of Google's in the years to come. However, Google's management believes that by excluding SBC, investors will be able to better make comparisons of core business operating results to other companies and over time.

While there are arguments both for and against non-GAAP performance measures, I see no downside in providing analysts as well as investors supplemental information that they may add back or eliminate in their models as they wish. Users of the financial statements and non-GAAP reconciliation can decide for themselves what measures they believe may be a better predictor of future earnings and cash flows.

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.

Based upon the stock-market charts for Google, it appears that the market reacted each quarter to the release of earnings information. Q1, Q3, and Q4 had upward spikes that immediately followed the release of earnings.

On April 18, 2013, Google reported an increase in revenue of 31 percent and an increase in earnings per share of almost 14 percent compared to the first quarter of 2012. The market responded with an increase in stock price of over 4 percent on the day following the first quarter earnings release and the stock price continued to rise for the following month.

On July 18, 2013, Google reported an increase in revenue of 19 percent and an increase in earnings per share of 13 percent compared to the second quarter of 2012. The market did not appear as impressed by those increases as it was for the first quarter. The stock price barely reacted to the earnings release.

On October 17, 2013, Google reported an increase in revenue of 12 percent and an increase in earnings per share of 34 percent compared to the third quarter of 2012. The market had a positive reaction to the increase in earnings per share and responded with a 13.8 percent increase in stock price on the day following the earnings release.

Finally, on January 30, 2014, Google reported an increase in revenue of 17 percent and an increase in earnings per share of 15 percent compared to the fourth quarter of 2012. The market responded to these results with a 4 percent increase in stock price on the day following the earnings release.

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 outperformed the NASDAQ composite index (IXIC) 54.95 percent to 33.12 percent for the year ended 2013. The market's reaction to Google earnings

release for the first quarter and even more so in the third quarter drove Google's performance well above that of the index.

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

Based upon the 4 percent increase in stock price in after-hours trading and the following day, I believe that the market perceived the earnings news in Google's press release dated January 30, 2014, as "good news". This initial leap in stock price was caused by an increase in revenue from the previous year. Once the dust had settled, the shares ended up only being up 2.6 percent.

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?

Initially following the press release, Google's shares leapt about 4 percent due to investors excitement about the revenue growth, which was slightly higher than analysts' expectations. However, Google only reported GAAP net income of $3.38 billion ($9.90 a share) which, while up from last year's earnings, fell short of analysts' expectations. Using non-GAAP measures, analysts had predicted that Google's earnings would be $12.20 a share, which was higher than the reported non-GAAP EPS of $12.01. Although Google fell short of their bottom line, they still saw a positive stock market reaction to the press release. I believe that the positive reaction might have had more to do with the announcement of the sale of the unprofitable Motorola to Lenovo and the belief that without Motorola's drag on profits, Google's future could be even brighter.

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?**

Several factors contributed to Google's revenue growth and resulting positive market reaction. The increase in revenue was partly driven by a 31 percent growth in clicks on search advertisements. While these numbers were still down from 2012, it was the highest reported in 2013. This overall decrease from 2012 was due to the shift from desktop computers to mobile phones, which pay less for advertisements. In an effort to stay on top of this issue, Google has developed image-based ads and "product listing ads" which have both been most successful.

Another reason for Google's revenue growth was the increase in app sales in the Google Play store, which doubled from the previous year.

Lastly, the sale of the unprofitable Motorola to Lenovo was seen favorably as it keeps Google focused on its core business with fewer distractions along with increasing Google's profits. The only factor that I see that could be concerning is the rapid increase in headcount by 1,700. In the same quarter as the announcement of the sale of a portion of the business, headcount increased by almost 4 percent, which could indicate a lack of cost control.

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