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AN ANALYSIS OF THE PRINCIPLES OF FINANCIAL REPORTING AND THEIR  
APPLICATIONS THROUGH THE USE OF CASE STUDIES

By

Thomas Keller Fowlkes

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

May 2020

Approved by:



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Advisor: Dr. Victoria Dickinson



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Reader: Dean Mark Wilder

## ABSTRACT

THOMAS FOWLKES: An Analysis of the Principles of Financial Reporting and their Applications Through the Use of Case Studies  
(Under the Direction of Dr. Victoria Dickinson)

The following thesis is a collection of case studies that were completed during two semesters of enrollment in Accounting 420, directed by Dr. Victoria Dickinson. It is presented as a fulfillment of the requirements for the University of Mississippi, the Sally McDonnell Barksdale Honors College, and the Professional Research and Development Thesis Program. While each of the twelve cases is different, they all provided a significant contribution to my own personal understanding of the principles of financial reporting and how those principles apply to the accounting profession. Each week of the thesis course, I would receive a different set of complex accounting questions, usually presented in conjunction with a specific company's financial statement and accounting strategies. These cases were not always based on real firms, but throughout the semester, the most rewarding and educational research revolved around real-life examples like WorldCom, Google, and Starbucks. The historical cases allowed me to explore human errors and helped me understand how those mistakes effected millions of dollars of public investment and thousands of jobs. Nevertheless, whether the cases had a base in history or not, they all asked deep, realistic questions that challenged my knowledge of accounting and its intersection with outward financial performance. Week-in and week-out the cases provided mysteries in the form of financial statements that each student in Accounting 420 had to decipher and solve. Many times, there wasn't a clear correct answer; rather, the cases provided many avenues to go down in search of an answer: many of these avenues led to acceptable conclusions, but many of them did not. Therefore, the thesis that I present reflects the way it was produced. It is the product of many wrong answers, many mistaken assumptions; however, in the end, with

the help of Dr. Dickinson, I have obtained a knowledge of the world of accounting that would not have been obtained without this constant trial and error.

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# Case 1: Alteryx

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# Case Study 1: Alteryx

## 1.1 Introduction

As our society has become more complex and interconnected, businesses began facing a new problem: a surplus of information. Whether it was introspective, regarding the company's efficiencies or inefficiencies, or outward looking, regarding the customer's response to marketing or their preference for certain products, companies simply did not have the resources to combat this issue alone. Thus, with this overarching need, specialized data companies began developing platforms by which the collection, combination, and presentation of massive amounts of information could become simpler. This is when the company Alteryx was born. In general, Alteryx's goal is to offer a multifaceted program through which companies can blend data from a wide range of sources into a clear, coherent, and visually appealing product that can be easily read, created, and contributed to by every agent in the company. While this all sounds like a bunch of jargon—and trust me there is a lot of it out there—the idea is simple: Alteryx offers 3 major tools that allow you to filter data through a shareable program that can be altered and contributed to by all those in your company. Does that make sense? Well, if not, let's look at how these three programs help companies make a plethora of business decisions.

## 1.2 How does Alteryx help make business decisions?

As mentioned previously, Alteryx provides a three-pronged data analyzing process— Alteryx's Designer, Analytics Gallery, and Server— that can aid a business in a variety of ways. First, the Alteryx Designer provides a relatively straightforward solution to the headaches of data accumulation. Its unique ability to repeat the same process— whereby data analysts can drop large files of metadata from the many different sources, like Microsoft Excel, into an established pattern— has put it ahead of many competitors. The Designer function starts with a blank

canvas, where users can drag different tools, which are divided based on their function—broadly range from “In/Out,” where data is read, “Preparation” where basic functions like filter and sort can be added, “Join,” where data is blended, and many others that become increasingly complex like “Transform,” and “Spatial”— and build the repeatable process previously referred to. For many businesses, the specific tools they use will depend on their certain desired needs; however, the Designer’s ability to let businesses build processes in which we can filter through millions of different data sets to find a specific trend makes it invaluable to businesses. Second, the Alteryx Gallery builds upon the repeatable workflow from Designer. With its main goal being to “create and deploy workflows in the cloud for anyone to access analytic applications at any time,” the Gallery allows all levels of company employees and agents are to find and employ Alteryx provided applications that specifically meet their needs. This way, managers across a company can access the same data from Designer but employ it in their own specific ways. These applications are all predesigned and serve the purpose of reducing the necessity of Alteryx consumers to be knowledgeable of code or any other highly technical information. Third, the Alteryx Server, in the words of the [alteryx.com](http://alteryx.com), “...provides the foundation for organizations with the enterprise scalability, automation and governance that is required across the analytics pipeline.” In laymen’s terms, the Server portion of Alteryx, goes deeper than the Gallery function, for it focuses on the business’ ability to share an Alteryx workflow with anyone, even a non-Alteryx user. With this in mind, the Server allows each individual manager, who has used a specific application in the Gallery for a specific reason, to save his workflow to a companywide database, thereby giving every manager in the company access to the way he filtered his data. This can be highly useful for international companies who have managers doing the same job across the world who all want to use their data to answer a plaguing question that comes with

that specific position. These three processes allow the inside analysts of a company to securely present a coherent combination of company data to every agent in their company.

**1.3 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:**

- Internal Auditing requires constant updating of internal financial numbers, known as Continuous Auditing, so that the company’s numbers do not vary drastically in the day-to-day operations of the company. Just like this internal necessity, the products that Alteryx provides allow auditors the ability to assess how often and varied audits within companies must be when different sectors exist in the company. For example, Southwest Airlines’ use of Alteryx allowed it to combine work load, work schedule, staffing, and performance score data— from totally different data collecting environments which made them difficult to combine— into a workflow that allows the auditors to make audit quantity decisions.
- Alteryx’s ability to extrapolate trends from large sets of data is the bedrock upon which its ability to answer previously unknowable questions is built. In a separate case study, done for a pharmaceutical company, the question was asked, “how can pharma companies monitor whether their sales reps are promoting the drug for “off-label” usage. Through the use of Alteryx’s workflow Designer, the company can pull sales rep expenses and call expense data from across all regions and doctors to evaluate which sectors are requiring unusual funds. Coupling this

workflow with the use of the Alteryx Server, a company can scale the workflow to the whole company; whereby offering each individual office manager the ability to compare his branch's financial data and sales rep numbers to those of branches who do not have an issue with promoting "off-label" usage.

- Because Alteryx's processing strength lies in its ability to blend data from multiple different sources and platforms, Multinational Corporations will benefit the most from the products, for when different country-specific input prices for labor and services effect the bottom line of different sectors, Alteryx will be able to process each unique dataset through the same filters. Thus, these multinational companies will be able to visualize where their efforts will be most profitable.

**Tax:**

- Similar to the previous example of labor and service input prices in multi-national companies, Alteryx will be able to provide the same general effect on the taxes of separate countries; however, this is not the same as the labor and services input, for Alteryx goes the next step with tax data: it can add data from country-wide census to any data set thereby giving the international corporation to not only make bottom-line decisions but also employee benefits decision. Wherever employees are being taxed higher or there is a prevalence of double taxation, Alteryx will be able to reveal the gross profit of the separate sectors and gross pay of the employees in each respective country.
- Secondly, as it pertains to the Alteryx Designer, the complex tax codes in the United States change frequently due to the federalist structure of our government as well as the popularity of tax reform in the national legislature; so, the ability to

alter the workflow in the Designer easily and make minute changes that can be applied to the same data will speed up the process of tax analysts. They will be able to shift their focus from the mind-numbing work of plunging in changed tax codes to analyzing the effects of those tax codes on the business' data and the decisions that must be made in response to those changes

- Finally, businesses that deal with their own customer's taxes can harness the power of the repeatable process that the workflow offers. They will be able to work with customer groups rather than do each customer's taxes individually. These companies will only need to set up a limited number of the repeatable workflows, and once they have completed that, all they must do is organize their customer's specific financials into the workflow they must go through. Therefore, in a progressive tax system, we can see the differences within certain tax levels by simply inserting customer financial data into the Designer and comparing them to the rest of the results.

**1.4 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 staffing and scope of your future engagements.**

TO: Robert Fisher

FROM: Thomas Fowlkes, CPA

DATE: 21 September, 2018

SUBJECT: Alteryx opportunity and investment positives

The world of big data and the need to rationalize it will not go away, and if we desire to be a company of the future and not of the past, we must adopt a strategy through which we can service any client, big or small. With this in mind, I argue that there is no better full-service data analysis program than that of Alteryx. It offers a start to finish product that allows us to study not only large amounts of numbers, but also the meaning behind them. The training costs will be minimal due to its non-coding nature, and even the employees who do not receive this training will be able to access and employ the program through the Alteryx Server and Galley options. Furthermore, the core product of Alteryx, the Designer, offers a variety of tools that can fit any sector we service— from Real Estate, to Medical, to Education.

In the future, I think that programs like these will have a harsh effect on employment opportunities within the public accounting sector; however, we are not alone, and technology will affect every sector in our globalized economy. The bright side is that companies will continue to need trained analytics interpreters to consult with them about the financial status of the business; therefore, in the future, we must look beyond our old hiring practices and into a goal of hiring people who can extrapolate trends and answer deeper questions than those that appear on a balance sheet or income statement.

# Case 2: Rocky Mountain Chocolate Factory, Inc.

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Tom Fowlkes

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**1.2 What I learned**

**1.3 Questions**

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## **Introduction**

This was the first time in my life that I had played the actual role of an accountant. Through this exercise, I was able to put my collective knowledge of accounting together, and saw first-hand the connections between each statement and the necessity of being accurate on the earliest statements. Without accurate denotation of the Journal and Income Statement, the final Balance Sheet and Cash Flows will be exponentially harder to calculate correctly. Furthermore, the entrance of tax into the income statement, which I have not had to deal with in a real-life example, taught me the costly reality of living in a highly taxed environment. Finally, after putting each statement together, I have realized the enormity of the accountant's job, for this is only a journal of 15 major entries, and with massive, multinational corporations, it is clear that the world's need for accountants will not soon fade.

## Questions

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

As far as my expectations go, I think that the balance sheet will consist of assets like cash, accounts receivable, and PPE; liabilities like accounts payable, and salaries and wages payable; and owners' equity accounts such as common stock and paid in capital in excess of par.

- 2. Based on the transactions recorded, list at least three adjustments or reclassifications that might need to be made prior to preparing the final financial statements.**

The three regular adjusting entries that could occur would be the Depreciation of Property, Plant, and Equipment, the adjustment of the inventory account, and the accrual or deferral of wages

Figure 2-1: Rocky Mountain Chocolate Factory, Inc. Balance Sheet

Rocky Mountain Chocolate Factory, Inc. Balance Sheet As of February 28, 2010		
<b>Assets</b>		
<b>Current Assets</b>		
Cash and Cash Equivalents	3,743,092	
Accounts Receivable	4,427,526	
Notes Receivable, current	91,059	
Inventories	3,281,447	
Other	220,163	
Total Current assets		\$ 11,763,287
<b>Long-term investments</b>		
Notes Receivable less current portion	263,650	
Goodwill, net	1,046,944	
Intangible Assets	110,025	
Other	88,050	
Total Long-term Investments		\$ 1,508,669
<b>Property, Plant, and Equipment</b>		
Property and Equipment, net	5,186,709	
		\$ 5,186,709
<b>Total Assets</b>		<b>\$ 18,458,665</b>
<b>Liabilities and Stockholder's Equity</b>		
<b>Current Liabilities</b>		
Accounts Payable	877,832	
Accrued Salaries and Wages Payable	646,156	
Other Accrued Expenses	946,528	
Dividends Payable	602,695	
Deferred Income	220,938	
Deferred Income Taxes	433,180	
Total Current Liabilities		\$ 3,727,329
<b>Stockholder's Equity</b>		
Common Stock	180,808	
Additional PIC	7,626,602	
Retained Earnings	6,923,927	
Total Stockholder's Equity		\$ 14,731,337
<b>Total Liabilities and Stockholder's Equity</b>		<b>\$ 18,458,666</b>

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

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

Figure 2-3: Rocky Mountain Chocolate Factory, Inc. Income Statement

Rocky Mountain Chocolate Factory, Inc... Income Statement For Year Ended 2/28/10		
Sales		22,944,017
Cost of Goods Sold		14,910,622
Gross Profit		\$ 8,033,395
Operating Expenses		
Sales and Marketing Expense	1,505,431	
General and Administrative Expense	2,422,147	
Retail Operations Expense	1,756,956	
Depreciation and Amortization Expense	698,580	6,383,114
Operating income		\$ 1,650,281
Other Revenues and gains		
Franchise and Royalty fees	5,492,531	5,492,531
		\$ 7,142,812
Other Expenses and losses		
Franchise Costs	1,499,477	1,499,477
EBIT		\$ 5,643,335
Taxes		
Income Tax Expense	2,090,468	2,090,468
Interest		
Interest Income	-27,210	-27,210
Net Income		\$ 3,525,657

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

Rocky Mountain Chocolate Factory, Inc. Statement of Cash Flows For Year Ending February 28, 2010	
Entries	Operating/ Investing, or Financing
1	Operating
2	Operating
3	Operating
4	Operating
5	Operating
6	Operating
7	Operating
8	Operating
9	Investing
10	Financing
11	N/A
12	N/A
13	N/A
14	N/A
15	N/A

## Case 3: Alteryx

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Tom Fowlkes

## **Overview and Takeaways:**

During this case, I was able to understand and think through different scenarios that I might encounter on my path toward a career choice. This case has opened my eyes to a few of the nuances that I must consider as I move toward an internship opportunity. I must be sure that the internship is being used as a positive and serious decision on my part to set myself up for a career in this field.

### **Scenario 1:**

**I overhear a conversation between two students while studying in Conner Hall, and as the conversation begins, I recognize that while both students are accounting majors, their plans for the future are very different. The first student plans to take on a full accounting curriculum, including the internship, but he wants to proceed straight from undergraduate into law school to study tax law instead of going to an accounting firm. He says that he knows tax law is very lucrative and that the internship will look better on his resume than anything else he could do. The second student listens to this and counters with the fact that the masters of accounting is less commitment financially and time-wise than law school, but if student one really wants to go to law school, he doesn't have to do the internship or dress up like everyone else for interviews. The conversation ends ambiguously with each side making their own points**

Thoughts on scenario 1:

This scenario reminds me of conversations I have had in my own head, for with the desire to go to law school and the knowledge that accounting is one of the best degrees I can obtain from the University of Mississippi, the thoughts of student one have occasionally crossed my mind. I believe that due to the financial commitment on behalf of the firms to woo Paterson



school students, I would be unethical if I hid my desire to attend law school during my interview process; however, if I am completely open with the firms and they still offer me, I will feel unbound ethically, for they will be knowledgeable of my intentions. As for the debate between law school and masters of accounting as it pertains to tax-based employment, I think it is a matter of finances of the student and overall desires for the career; however, job placement out of the Patterson school is 100% while law positions have lower promised employment.

**Scenario 2:**

**Once again, I am in Conner Hall, and a conversation between three students arises. The first student is not into accounting at all; however, because of the school's high rank he wants to leverage that degree to follow his dreams into an investment bank. The second student has the same general thoughts as student one; however, she wants to go into consulting and sees that case competitions in the accounting school will prepare her well for that. Furthermore, student two needs to save up money for an MBA program and will stay at her accounting job for one to two years before she goes back for her MBA. Finally, student three argues that students one and two should major in financing and consulting, respectively.**

Thoughts on scenario 2:

I have seen these arguments from my brother as he made his way through the Patterson school, and while he has taken his job with an accounting firm, he and many of his friends have the final goal of moving into investment banking or consulting from the accounting world. The first student argues that investment banks like accounting major because they know we know how to work long hours; however, that is not exclusive to accounting majors, and I would argue

that to go into finance, you would be better served with a finance degree and a few years of work out of school, for your knowledge of the specifics of finance is in my opinion more important than your willingness to work. For the second student, the understanding of the accounting firm's investment weighs more on me than the desire to go get my MBA a year earlier. What I mean by this is that if we attempt to use the firm's connections and money to get into another field while making the firm pay for our MBA without any commitment to return to that firm is unethical. Morally, the student should not allow themselves to treat the firm like that; however, if one does not treat the company unethically, then the desire to get an MBA and go into consulting is a great path from accounting in my view. So, in closing, I would argue that student three's argument is the most ethically sound, for if one tries to use a firm simply for its funds and connections without regard to its personal investment in you, that will not lead to a good, personal business reputation.

### **Scenario 3**

**In this final scenario, a student has interned with one of the big 4 in Washington D.C., and has accepted an offer there; however, she has had a change of heart and wants to obtain a transfer offer to her hometown in Dallas, TX. She is willing to move out of the big 4 to go to Dallas.**

Thoughts on Scenario 3:

This final scenario renews the debate on whether the employee/ student owes anything to the company or branch of the company that has employed them and invested in them. In my view, this student has a duty to stay with that same accounting firm that has trained her and has promised to employ her. Furthermore, the DC branch has borne the highest cost within that company; however, I am not blind to the fact that occasionally there are circumstances that

require a move. Therefore, in this scenario, I would talk to my most trusted ally in the DC branch and ask for their advice. If this ally is very adamant about staying in the DC area for a short amount of time in order for the firm to recoup its losses, I would take him at his word and sacrifice for the amount of time that they desire. No matter what, I would tell the student to stay within the big 4 no matter what. Even if Dallas is your dream city, the opportunity cost of leaving the big 4 will be great, and why, early in one's career, would one want to limit long-term earnings simply for a return to the hometown. This student needs to sacrifice a little comfort in order to have as many options in the long-term as possible.

# Case 4: Generic Bank

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**1.2 What I learned**

**1.3 Questions**

## **1.1 Executive Summary**

Throughout this case, there were questions that revolved around the ethics and laws of financial statement reporting as it pertained to impaired securities. In the first two requirements, we were asked to assess the necessity of reporting impairment losses based on the sale of seven securities and then all the securities. I found that in the former, only two securities must be reported as impaired, while on the latter, I argue that the financial stability of the company does not require any action. Thirdly I found that as an external auditor, we would have to hold the company to a higher ethical standard as it pertains to advising their investors while as a bank regulator, Generic Bank's solid financials would stop give the institution a fair amount of leeway. Fourth, I addressed the question about the securities sold at net gains, and while I found that if all securities were sold at a gain, then there would be no impairment, if only the seven were sold at a net gain, Generic Bank would be more likely to need to impair their securities. Finally, if Generic bank has only an adequately capitalized institution, I argue that they must report a greater number of impaired securities due to their lack in ability to insure investors that they will be able to hold them until maturity.

## **1.2 What I Learned**

This case was highly informative on the intricacies of the FASB as well as the ethical grey areas that well-financed, well-meaning companies can come across. Generic Bank's firm foundation of well capitalized endeavors offers it some leeway when it comes to realizing losses; however, the lack of ethical behavior insofar as the company's recent balance sheet not telling investors of their intent to sell the impaired securities would cause concern for an investor like me. An auditor must be able to have an arm's length relationship with this type of moral ambiguity and nip it in the bud. Without a meticulous, trustworthy external auditor, this company would be able

to continually mislead its future investors as well as, the case of requirement five, put the whole company in danger if impairments are not declared.

Furthermore, this introduction to the Accounting Standards Codification was truly the first time I have had contact with the document. I was able to understand its use and realize the asset that is can be toward an accountant when dealing with an unknown problem. While I do not completely understand the correct actions that the bank needs to undertake, this case allowed me to understand a portion of intricate accounting decisions that I otherwise would not have seen.

## 1.3 Questions

- 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?**

According to ASC 326, a security is impaired when its Fair Value declines below its amortized cost basis; however, just because impairment is present, doesn't necessarily result in recognition of a credit loss. Nevertheless, even with ASC 326, I argue that the impairment loss occurred due to ASC 320, wherein the intent to sell an impaired security is addressed. On the 20x2 balance sheet, management had no intent to sell these securities, and even if the securities had losses, management wouldn't have to report the impaired securities if they had the intent and ability to hold the securities until the losses had recovered; however, since management made the decision to sell so soon after their declared intent to keep, and also since the securities realized losses, management does have an impairment loss on all but securities 67 and 96 in the balance sheet as of 20x2. In my opinion this is more about intent than any other factor, for they are misleading their investors if they state their intent to hold then securities when they sell so soon after.

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

As seen in ASC paragraph 360-10-35-47, "a long-lived asset to be abandoned is disposed of when it ceases to be used. If an entity commits to a plan to abandon a long-lived asset before the end of its previously estimated useful life, depreciation estimates shall be revised in accordance



with FASB ASC Topic 250, Accounting Changes and Error Corrections, to reflect the use of the asset over its shortened useful life.” With this in mind, and our knowledge that Generic Bank plans on holding the remainder of these securities long-term, we will not need to report any excess impairment losses due to their intent to keep securities until the temporary losses have been regained. Furthermore, According to Commission (SEC) Staff Accounting Bulletin No. 59, *Other than Temporary Impairment of Certain Investments in Equity Securities*, there are three issues to be considered when determining the impairment of a security: time and extent of loss, the issuers financial condition, and the intent and ability of the holder (SEC.gov). Generic bank is financially sound, has the intent to hold the securities, and none of the losses appear long-term or extraordinarily large.

**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?**

*As an external auditor:* I would be concerned with the ethical history of the Bank. This main issue occurs when dealing with intent, for as seen in Auditing Fair Value Measurements and Disclosures (section 328), it is stated that, “The auditor should evaluate management's intent to carry out specific courses of action where intent is relevant to the use of fair value measurements, the related requirements involving presentation and disclosures, and how changes in fair values are reported in financial statements.” When seeing the bank unload the impaired securities soon after informing their investors of their intent not to sell them, as an auditor I would be highly suspect of their true intent. While this does require knowledge of the company’s

leaders and a look back at the history of decisions, as an auditor, I would at least include in my report that the company has previously misled investors and needs to reevaluate their decisions on intent. If a bonus is the only reason for the company to sell bonds that might otherwise realize a long-term gain, then it is apparent that the company is self-serving.

*As a bank regulator:* As a bank regulator, it is my duty to make sure that banks meet certain requirements restrictions and guidelines designed to create market transparency between banking institutions and the individuals and corporations with whom they conduct business (Farlex Financial Dictionary, 2007). However, while as a bank regulator I am frustrated about the lack of transparency on the balance sheets and the misleading of investors in regards to the intent of management to sell the company, if the bank maintains its capital requirements and follow interest rate guidelines, as does the Generic Bank, then I will not be worried with the actions of Generic Bank. If the bank was not so well capitalized and therefore its actions posed a threat to the investments of others, then I would have to step in; however, that is not the case.

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

Even if the securities had been sold collectively in the net gain position, I would have to investigate as to whether each individual security was sold at a gain. In both of this situations, requirement one and two, there is still an issue with intent. If the managers still sell after misrepresenting intent and there are still certain individual securities that recognize a loss, then Generic Bank must report the impairment of those securities. Even in light of the net gain

position, there is a conflict of interest that can occur with the lack of reporting non-loss interactions, for allowing this action would give managers the ability to hide enormous losses on a few securities behind a wall of small gains. Nevertheless, seeing as the firm is still well capitalized, as it pertains to the second requirement, a sale of all securities in a gain (rather than net gain) position would be permissible and lack the necessity for impairment recognition. If all are sold at a gain, then inherently none of the securities would garner less than their amortized cost.

**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:**

If the Generic Bank is only adequately capitalized rather than well capitalized and the sale of securities occurs due to a lack of capital and desire to improve capital ratios, then there is reason to believe that impairment might have occurred on securities other than that of the seven. This is so because, due to the issue with company solvency, the company may not be able to hold all the securities which currently have losses until they have realized their gains. If the company is not able to truthfully report to its investors that it is able to keep the securities until the temporary losses. As the FASB states in paragraphs 320-10-35-8 and 9, the circumstances surrounding the sale of securities that are classified as held to maturity (HTM) can incite questions as to the remaining securities that remain in the HTM category (FASB, 2016- 13). If the lack of financial stability is the reason behind the sale, then these HTM securities might need to be switched into an Available-For-Sale document and subsequently listed as impaired on the previous year's balance sheet.



# Case 5: Tale of Two Cities

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Tom Fowlkes

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**1.1 Executive Summary**

**1.2 Memphis, TN**

**1.3 New York City, NY**

**1.4 Deliberation**

## **1.1 Executive Summary**

Throughout this case, I was able to look more deeply at a city I've known all my life and a city that is relatively foreign. I found that while much is different, much is the same. They both offer entertainment and opportunity, but have a starkly different make-up of culture and business industry. Memphis is home and always will be. Its mainstays of transportation, healthcare, logistics, and agriculture are not by any means small-time; however, in contrast, New York City's seemingly endless specialties of business baffle the mind. After the answers to the questions, I end this study with a statement of preference and of lessons learned. There aren't many times in life where you sit down and evaluate two possibilities that seem so different from each other. This exercise in research has helped me form a fuller view of my options in the accounting field and city choices.

## **1.2 Memphis**

### **1. What is the population?**

652,236 people

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

There are basically only two seasons in Memphis, TN: summer and winter. The summer starts around the end of march and lasts until late September while the winter picks up where summer leaves off. Although there are a few weeks in between each season where it feels "sunny and 75," much of the summer is hot and very humid while much of the winter is cold, windy, and rainy.

**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.**

The city is moderately flat like the delta that surrounds it, however, it is protected from the might Mississippi river by the tall 4<sup>th</sup> Chickasaw Bluff. The city, formally the hardwood tree capital of the world, is covered with mighty southern oaks and pines. Located right across the river from Arkansas and right north of Mississippi, Memphis has one of the largest city parks in the U.S, Shelby farms (as seen in this picture). Also, while its downtown is not huge, its expansive eastward suburbs provide room for homes and yards.

*Figure 5-1: Shelby Farms park from an aerial view*



**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'd be likely to pay. Quantify what this means based on a starting salary of approximately \$50,000/year)?**

Tennessee does not have a state income tax; however, Tennessee does tax dividend and interest earnings. There is no local income tax either. Property tax, however, is calculated on a federalist level: meaning you pay the \$4.05 per \$100 Shelby county tax as well as the \$3.19 per \$100 value Memphis tax. Assuming one can control his buying practices, for the sales tax is 9.25 percent, then a worker on \$50,000/yr should expect to keep the majority of his income, then pay based on



his use of property and consumption of goods or services. Also, I will have to pay by Federal and FICA taxes.

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

Memphis International Airport services daily flights to many of the larger hubs like Atlanta, Dallas, Washington, D.C, and New York City. While it is not the biggest airport by far, it is hardly ever crowded and gets you where you need to go- albeit with a connection through Atlanta most of the times. Also, the bridges over the Mississippi are the closest major crossing for nearly 50 miles on each side.

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

The city's most prevalent industries are transportation, logistics, and healthcare. With a huge intermodal facility which handles 327,000 containers and trailers annually, it takes a lot of manpower to organize all those moving parts. Also, companies like Fedex and International Paper lead the employment charts. Healthcare, rooted through the University of Tennessee Medical School, Lebonheur, and St. Jude, research cures and heal thousands of people a year.

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

Memphis is home to two of the country's foremost children's hospitals in Lebonheur and St. Jude. Additionally, while the downtown hospital (the Med) and the VA hospital need monetary aid and physical repair, the hospitals located in the suburbs like Methodist, Baptist, and St. Francis, are all capable and well-functioning.

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

While property crime is more frequent (57.31 out of every 1000 citizens affected), violent crime is not rare (18.33 out of every 1000 citizens). Property crime like burglary, theft, and motor vehicle theft affect many in the city. Within the city center, in the north and in the south of Memphis is where the majority of crime takes place. Moving directly east of the city center and expanding north and south gradually, crime is down to a minimum.

**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.**

Many young people live in downtown Memphis in new condo developments. Complexes like the redone Hotel Chisca and the new development at the old Tennessee brewery offer apartments for around \$975 dollars a month and they are on the pricey end. For a 665-foot studio apartment at Hotel Chisca, in the center of the city, you can pay \$1000 a month. Parking is provided through a parking garage and there is a gym within the complex.

Secondly, at the Tennessee Brewery complex, you can get 635 square feet for \$1055 per month. Both of these options do not require a roommate, and the Brewery does not offer a gym but instead has a fully functioning bar on the ground floor. Both of these options have laundry rooms on their main floors for a price per use.

Figure 5-2: Hotel Chisca floor plan and street view



Figure 5-3: Layout of Tennessee Brewery apartments



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

The typical modes of commuting are by car, and, as the old adage goes, you can get anywhere in Memphis in about 20 minutes. However, if I live and work downtown, my commutes will be closer to 5 to 10 minutes.

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

In downtown Memphis, there is a farmer's market every Saturday, and local grocery stores do survive in downtown Memphis; however, Kroger, Sprouts, and Whole Foods are the mainstays of large grocery shopping in Memphis. In the future, as has just become a service in Memphis, amazon grocery delivery might be an option.

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

I will do my laundry at the apartment buildings which I have mentioned in this prior report. There are also numerous dry-cleaning services downtown that are quick and cheap.

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

There is a civic organization among millennials in Memphis known as the New Memphis Institute, and with fellow young people, I would be able to become involved in city politics and social functions. Secondly, within the church, I would like to be heavily involved in a Presbyterian church, its outreach, and its weekly activities. Finally, I would like to aid the St Mary's Soup Kitchen downtown that would aid the public and underprivileged.

**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.**

The Memphis grizzlies and Memphis redbirds (baseball) are my favorite teams to follow in Memphis; however, the University of Memphis basketball team, led by Penny Hardaway, will be exciting as ever. There are local running clubs sponsored by breakaway athletics as well as kayak clubs that train heavily on the Mississippi river. Finally, there are multiple music lounges that feature 5-star blues/rock and roll talent that I greatly enjoy listening to.

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

I am from Memphis and will hope for cheap gas prices back home.

**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.**

*Figure 5-4 Estimated Expenses living in Memphis*

Revenue	5000	
Income Taxes	-1060.75	Federal, FICA
Rent Exp	-1000	
Groceries	-300	Three trips of \$100 each
Internet/Utilities	-180	
Dinner's Out	-300	\$10 per day
Entertainment	-1000	\$33.37 per day
Gas	-156	two 26 gallon tanks
<b>Final for Savings</b>	<b>2064</b>	

## **1.3 New York City, NY**

### **1. What is the population?**

The population of New York City was 8,622,698 as of July 1, 2017.

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

New York weather is very changeable with moderate rainfall all year. The summers can be hot while the winter is incredibly cold. The spring comes in April along with a heavy rainfall.

### **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.**

New York City is separated into five boroughs: Manhattan, Queens, The Bronx, Brooklyn, and Staten Island. Each of these 5 burrows are not especially different as it comes to altitude; however, two rivers, the Hudson and the East, separate Manhattan and the Bronx from Brooklyn, Queens, and Staten Island. While Manhattan is full of skyscrapers except for the 843-acre Central Park (see image). Queens, the host of JFK and LaGuardia Airport, is the second largest borough and is a cultural melting pot and contains mixed-use living and working districts. Brooklyn, the most populated borough, houses many of the families and living units in NYC. Finally, the Bronx and Staten island and the smaller two boroughs; have rich cultural histories but are farther away and contain more housing units and less business office.

*Figure 5-5: Images of Central Park in NYC and the Five Boroughs*



**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'd be likely to pay. Quantify what this means based on a starting salary of approximately \$50,000/year)?**

The tax rates within Manhattan would cause my income tax to be around \$2,378, which is a rate of 4.76 percent. Furthermore, the Federal taxes would result in an effective tax rate of 11.28 percent and a FICA tax of 7.65 percent. While there are no local taxes, my total income tax payment per year will be around \$11,800.

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

New York city contains Subways at nearly every street corner. Grand Central Station, which houses both passenger trains and subways, can get you anywhere inside and outside of New York. Two of the largest airports in the world, JFK and LaGuardia, can fly you anywhere in the world.

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

Well, the short answer is everything, but New York City is most prominently known for the Financial Industry. The New York Stock Exchange, Wall Street, and the U.S headquarters of almost all the major world banks. Furthermore, Fashion is an incredibly strong industry as well as the financial law practice and M&A work. Also, professional services like accountants, mechanics and marketers make a good living in the city.

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

Hospitals like New York- Presbyterian, Mount Sinai and NYU Langone Medical Center were 3 of the 10 nationally ranked hospitals that are located in New York City. With high levels of neurology and neurosurgery research, the city is aggressively searching for medical answers. As it pertains to healthcare for the average New Yorker, there are 100's of hospitals and minor care clinics in the city.

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

Crime in New York city comes in all types, from white-collar to non-violent, to violent. The most expensive crime occurs on Wall-Street, but I digress. Affecting the common man however, theft is by far the most common, while assault and robbery are close behind. Murder rates are very low; however, the rape statistics and burglaries are statistically significant. Stay away from central park and West Harlem at night and stay on main roads.

**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.**



One can expect to pay anywhere from \$1000-\$2000 a month for rent. If I live in Manhattan for my first 3 years, which would be close to my employer's main office, then I cannot expect any floor space or much room at all. In Manhattan, there is a 1 bedroom, 1 bath for \$900 a month with 200 sq. ft. Secondly, I could live outside the center city in Brooklyn. If I want to be close to Manhattan, however, I have to be willing to pay a higher price. There is a studio apartment with 1 bath for \$1,500. Both of these apartments offer laundry rooms on the ground floor, have no necessity for a roommate, no parking, and limited square footage. Airbnb has significantly decreased broker costs and has allowed for people to live cheaper.

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

The typical ways to travel are subway, Uber, Lyft, taxi, and walking when in the center city. IN Manhattan, I would have a 20 to 30-minute walk to the office most likely, while in Brooklyn my commute time, depending on traffic and subway congestion, would be between 45 minutes and an hour.

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

The only way to efficiently get groceries within the city center is delivery with amazon prime or target. Outside of the city center, there are options like target and whole foods, but they are very pricey due to high rent costs and limited resources.

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

Both of my proposed living options provide laundry in the basement of their buildings, and there is a dry cleaner no more than 5 blocks away from any point: from the mouth of an actual New Yorker.

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

The two major religious organizations I want to involve myself in within the city are Hillsong Church as well as Redeemer Presbyterian: the current and former churches of pastor Tim Keller. Finally, I would like to become a member of a local boys and girls club which are spread throughout every neighborhood in NYC.

**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.**

Within the city, the comedy cellar has always been a destination for me. Also, the famous Madison square garden, home to the Knicks, as well as the Yankee's Stadium are great places to visit. Finally, Saturday Night Live and other late shows would offer some laughs and late night activates

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

The plane flights, round trip, from New York City to Memphis, TN, are \$300. If I can purchase flights early enough to not incur the penalties of Christmas and Thanksgiving price surges, this cost will be easy to anticipate

**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.**

*Figure 5-6: Estimated Living Expenses in New York City*

Revenue	5000	
Income Taxes	-1312.58	State, Federal, FICA per month
Rent Exp	-1500	
Groceries	-150	Two trips x \$75
Internet/Utilities	-180	
Dinner's Out	-300	\$10 per day
Entertainment	-500	\$125 per week
Transportation	-160	\$120 subway pass/ \$40 uber for month
<b>Final for Savings</b>	<b>897.42</b>	

## **1.4 Deliberation**

**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?**

I think that both of these cities offer an incredibly unique experience to the fresh young accountant and businessman. One with the warmth of home and the other with the excitement of

possibilities. I do not see either as better or worse, simply different. I still would be interested in living in these two cities, for with New York, I get to embark on the adventure of a lifetime while in Memphis I get so deepen the connections and friendships that I have come to cherish so much. In New York, the business possibilities are as endless as the concrete. While in Memphis, the chance to stay by my family, land, and equally attainable, lucrative business success offers a different draw. The money will not flow out as fast in Memphis than in New York, but also the chance of me being involved in a violent crime is larger there than in the Big Apple. No travel expenses for the respite of home exist in Memphis, but the ability to make my own name doesn't either. It is truly a difficult choice, and one that I have not been able to decide upon yet. I think, if asked today, I would say New York, because as much as I love and know Memphis, I know that it will be waiting for me when I get back. New York will keep on moving.

# Case 6: WorldCom

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Tom Fowlkes

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**1.1 Executive Summary**

**1.2 Questions**

## **1.1 Executive Summary**

WorldCom is a case that is near to the heart of many in the south. This case shows us a clear example of how the capitalization of assets can affect the income reporting of a company. Without correct oversight of expenditure capitalization, a company like WorldCom can misrepresent their financial standing and harm the pocketbooks of millions of Americans. Also, the effect that this event had upon the accounting landscape is equally as remarkable. As a result of this and other accounting scandals during that period, many of the restrictions and regulations we see in the accounting world today have arisen: Sarbanes-Oxley being the most notable.

Seeing the true effects of this case in the long-term stability of one of the largest accounting firms in the world reveals to me the true effect that an accounting error or misrepresentation can cause. I would recommend this case to all Ole Miss accounting students due not only to its connection to Mississippi but also to its widespread effect on the world of accounting. No matter where I go in the field of accounting, the repercussions of this case will be evident. Furthermore, the capitalization of expenses is a constant temptation that can easily make the financial statements look better; therefore, my career as an accountant will likely deal with checking the accuracy of these accounts at some point.

## 1.2 Questions

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

- i.* Assets are the items owned by an entity that are expected to provide revenue or economic benefit in the future and that were obtained through past actions. An expense is when the company uses up an asset or adds to its liabilities in expectation of fulfilling an obligation or growing the possibility of future cash flows.
- ii.* If an asset is likely to produce future benefits, then a company might have the ability to capitalize the asset; however, if certain costs only provide a one-time value for the company they should not be capitalized. Companies also must consider the upgrading of a current asset in a way that increases the value of the asset, it can be capitalized.

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

- i.* Capitalizing the costs will spread out the expenses, through depreciation, across multiple periods rather than just one; thus, the income statement will report higher net income than if the expenses were immediately recognized.
- ii.* The balance sheet will be affected by increasing the assets when the costs are capitalized and the stockholder’s equity will be increased at first but overtime will not be affected very much.



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

- i. The line costs for 2001 were stated as \$14.739 billion. Line costs occur when the company uses a separate company’s phone lines and communications equipment to run their own services. Thus, the line cost expense was being paid from WorldCom to another company like AT&T. **(Journal entry in billions)**

Line Costs Expense	14.739
Accounts Payable	14.739

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

- i. The line costs, \$3.1 billion in total, were improperly capitalized, for while GAAP states that they should have been within operating expenses, they were charged as a capital expenditure
- ii. The transactions occur when WorldCom used the other company’s equipment to fulfill services for customers, and rather than expensing it as costs of doing business (operation costs), they treated it like it was an asset that would create future revenue which it clearly was not.
- iii. This capitalization does not fulfill the threshold of being an asset, for it will not provide future revenues for the company by any stretch of the imagination.

- 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 cashflows? (Journal Entry in billions)**

Property Plant and Equipment	\$3.055
Cash	\$3.055

If improperly journalized, the investment section of the cash flows would show the investment in new lines; however, because they are improper and shouldn't be stated as they are, the journal entry would have reduced cash through the operating section.

- 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 (Use 22 years as the depreciation length midpoint and come up with annual depreciation on those amounts: quarter 1 will be annual amounts and then do them as quarters. That will be adjustment of final parts in) (Journal Entries in millions)**

Depreciation Expense	\$83.307
Accumulated Depreciation	\$83.307

- 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?**

**(Entries in millions)**

Income before tax	2,393
Depreciation for the year	83.307
Line costs, improperly capitalized	(3,055)
Loss before taxes	(578.693)
Income tax benefit (35%)	202.542
Minority interest	<u>35.000</u>
Loss, net	341.151

Yes, this change in net income is material.

# Case 7: Starbucks Corporation

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Tom Fowlkes

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**1.1 Executive Summary**

**1.2 What I learned**

**1.3 Questions**

## **1.1 Executive Summary**

The study of the financials of Starbucks Corporation reveal an archetype of what many fast-food, cash-heavy corporations look like from a financial statement level. First, we are asked to grasp a basic understanding of the Corporation in terms of its revenue streams, type of financial statements, corporate structure, and external auditors. Then, after placing the financial statements into more readable locations, we are asked to find ratios within the data and interpret their meaning and purpose.

## **1.2 What I Learned**

This case on the Starbucks Corporation reveals some of the work that financial analysts, company officers, and accounting firms do to try and understand the meaning behind the massive data presented on financial statements. Finding the changes from year to year, and then locating the reason behind that change within the notes helped me understand the relationship between the two. Without the notes to understand the legal fees and their non-recurrence, I would not have been able to deduct why the company had listed the legal fees in the operating income/loss section rather than in general and administrative.

Furthermore, being able to use my previous accounting knowledge to navigate the financial statements and find what numbers should be used in the ratios helped me sharpen my skills as it pertains to real-world accounting. This case taught me how to quickly find the accounts I am looking for and match them, through excel, with those numbers that come together with it to form an informative ratio.

## 1.3 Questions

**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 makes its money through selling food and drink products to their walk-in, drive-thru, and catered customers. Also, a sizeable amount of their business comes from their wholesaling of coffee beans and coffee making equipment. Compared to an average gas-station cup of coffee, Starbucks' products are of higher quality and more expensive. In terms of the financial statements, the large amount of cash and cash-equivalents proves that Starbucks' business comes mainly from these product sales.

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

**What titles does Starbucks give these statements? What does "consolidated" mean?**

The common financial statements prepared for external reporting purposes are the Income Statement, Balance Sheet, Statement of Stockholder's Equity, and the Statement of Cash Flows. Starbucks' gives the names of these statements "Consolidated Statement of Earnings," "Consolidated Balance Sheet," "Consolidated Statement of Equity," and "Consolidated Statement of Cash Flows." The word "consolidated" reveals that the numbers presented on the statements are aggregations of all parent and subsidiary companies.

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

Publicly traded companies prepare quarterly financial statements during the year; thus, each company has 4 reports throughout the year.

**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.**

The officers of the company are responsible for the financial statements. That means that the Chief Executive Officer and the Chief Financial Officer must overlook and sign off on the financial statement process. Once the reports are compiled, the external users, usually stockholders or market analysts, will be very interested to see how Starbucks' performed against its own projections and competitors. Furthermore, the company's own management will be using the financial statements to analyze trends and plan for the future.

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

Starbucks' external auditor is Deloitte & Touche LLP, with the audit team located in Seattle, Washington.

The first opinion letter that Starbucks' received was affirmation that Deloitte had audited their financial statements ending September 29, 2013. Deloitte states that it audited Starbucks in accordance with all standards of the PCAOB. In the close of this first letter, Deloitte opines that the financial statements are presented fairly. The second letter states



that Deloitte audited the internal controls of Starbucks' financial reporting as of September 29, 2013. It goes on to state what is required of internal controls and finally opines that Starbucks has maintained effective internal controls in the previous year. Both opinions are dated several months after Starbucks' year-end because it takes months for auditors to complete their work on large financial statements and ensure that their audit is accurate.

Deloitte concluded by issuing an unqualified opinion for Starbucks, meaning that their financial statements complied PCAOB standards.

**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](http://investor.starbucks.com)—contains a link to SEC filings. The company's Form 10-K can be found under annual filings and contains an Excel spreadsheet with financial statement data that may be helpful in creating the common-size statements).**

Figure 7-1: Starbucks Consolidated Balance Sheet

<b>Consolidated Balance Sheets</b>	<b>2013</b>	<b>2012</b>
<b>Current assets:</b>		
Cash and cash equivalents	22%	14%
Short-term investments	6%	10%
Accounts receivable, net	5%	6%
Inventories	10%	15%
Prepaid expenses and other current assets	2%	2%
Deferred income taxes, net	2%	3%
Total current assets	48%	51%
Long-term investments	1%	1%
Equity and cost investments	4%	6%
Property, plant and equipment, net	28%	32%
Deferred income taxes, net	8%	1%
Other assets	2%	2%
Other intangible assets	2%	2%
Goodwill	7%	5%
<b>TOTAL ASSETS</b>		
<b>Current liabilities:</b>		
Accounts payable	7%	13%
Accrued litigation charge	40%	0%
Accrued liabilities	18%	37%
Insurance reserves	3%	5%
Deferred revenue	9%	16%
Total current liabilities	76%	71%
Long-term debt	18%	18%
Other long-term liabilities	5%	11%
Total liabilities		
<b>Shareholders' equity:</b>		
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%	0%
Additional paid-in capital	6%	1%
Retained earnings	92%	99%
Accumulated other comprehensive income	1%	0%
Total shareholders' equity	100%	100%
<b>Consolidated Balance Sheets</b>		
Noncontrolling interests		
Total equity		
<b>TOTAL LIABILITIES AND EQUITY</b>		

Figure 7-2: Starbucks's Consolidated Income Statement

<b>Consolidated Income Statement</b>	<b>2013</b>	<b>2012</b>
<b>Net revenues:</b>		
Company-operated stores	79%	79%
Licensed stores	9%	9%
CPG, foodservice and other	12%	12%
Total net revenues	100%	100%
Cost of sales including occupancy costs	43%	44%
Store operating expenses	29%	29%
Other operating expenses	3%	3%
Depreciation and amortization expenses	4%	4%
General and administrative expenses	6%	6%
Litigation charge	19%	0%
Total operating expenses	104%	87%
Gain on sale of properties	0%	0%
Income from equity investees	2%	2%
Operating income	-2%	15%
Interest income and other, net	1%	1%
Interest expense	0%	0%
Earnings before income taxes	-2%	15%
Income taxes	-2%	5%
Net earnings including noncontrolling interests	0%	10%

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

**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 are cash, inventories, and PPE. The short-term assets make up 48 percent of the total assets, and the long-term assets make up 52 percent. This seems appropriate for a company like Starbucks that is involved in millions of transactions per day and cannot convert the cash into long term-investments very quickly. Furthermore, the Property Plant and Equipment fits logically into the company's business model, for it does all of its business in company-owned, brick-and-mortar stores and fulfills customers' requests with high-tech equipment.

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

Intangible assets are such as copyrights and trademarks that customer's value and understand to be of higher-quality than competitors. On the other hand, goodwill has occurred through the purchase of other companies and it includes the price Starbucks paid over the value of the purchased company's value.

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

Most of Starbuck's financing comes from retained earnings. It has used most of its year's earnings to plow money back into the company, and only around 20 percent of financing comes 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?**

As it pertains to company-operated stores, revenue is recognized when payment is tendered at the point of sale; however, licensed store revenues, like shipments of tea and coffee as well as related shipping costs, are recognized upon the shipment to the licensees. Gift cards are recognized at the time of use or at a reasonable time when the likelihood of redemption is high.

**ii. What are Starbucks' major expenses?**

The main costs that Starbucks incurs during the year are cost of sales including occupancy costs, which makes up 43 percent of total net revenues, store expenses, which makes up 29 percent of net revenues, and litigation charges, which made up 19 percent.

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

The only significant change of expenses from year to year occurred when Craft sued Starbucks and increased the litigation expenses by 19 percent.

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

The decision occurred due to the fact that the litigation expense is not recurring and will not proceed into the future. This litigation expense was due to a long-running suit with Kraft foods over the selling of Starbucks' coffee in grocery stores. If it had been an ongoing suit, then a general and administrative expense delineation may have been more appropriate.

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

In 2013, the company reported a -325.4-operating income; thus, Starbucks did not remain profitable in the strictest terms; however, due to the one-time litigation as well as the negative income taxes, the company reported a gross profit of 8.8 million dollars. In 2012, the company was profitable without a doubt. They reported an operating income of 674 million dollars, and an after-tax profit of 1,384 million dollars.

**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 earnings and net cash provided by operating expense appears to be the adjustment that followed the litigation charge.

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

The amount of purchases property, plant, and equipment purchased in 2013 was worth 1,151.20 million dollars.

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

Starbucks declared 669 million dollars of dividends but paid 629 million dollars' worth of dividends. The company declared a greater amount of dividends than it paid. The reasons for this can vary but could have come from the company declaring a dividend and not paying it by statement date, or the company could have paid cash-based dividends at the beginning of the fiscal year from last year.

**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?**

Some of the accounts that require estimates and assumptions on this balance sheet are goodwill impairments, stock-based compensation forfeiture rates, future asset retirement obligations, and inventory reserves. Additionally, further assumptions are required for unredeemed store value cards, and the potential outcome of future tax consequences. Also, the allowance for doubtful accounts, estimates related to depreciation and amortization, and warranty expense will require these estimates. The accounts that may be estimate free include cash and cash equivalents and prepaid expenses.

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

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Tom Fowlkes



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**1.2 What I Learned**

**1.3 Questions**

## **1.1 Executive Summary**

The BP oil spill that began on April 20, 2010, sent more than 200-million-gallons of oil into the Gulf of Mexico over a 6-month period. As of 2011, 150,000 claims for damages had been made and 400 lawsuits were filed: a reality which caused BP to have to revisit their strategies of contingent liability accounting. The BP accountants were forced to decide which of these claims were probable and estimable while deciding which were frivolous and unlikely. As of today, BP has allotted twenty billion dollars for the use of awarding damages to those effected by the oil spill: almost twenty billion dollars less than is estimated to have occurred because of the spill. Throughout this case, the realities of accounting in the face of vast contingent liabilities is addressed and discovered.

## **1.2 What I learned**

This is the first investigation into the world of contingent liabilities that I have experienced. While learning the theory of how to journalize them and the effect they have on the financial statements is important seeing how they act in a real-world example lets me put a name to a face— in the proverbial sense. The different decisions that the accountants can make in response to an event like this puts the pressures of the profession into perspective. If accountants overvalue the contingent liabilities, BP could face a massive drop in share value and investor trust, but if the estimates are undervalued, investors could be tricked into believing the company will quickly and easily recover. The accounting profession deals with a multitude of complex issues every day, but through this case, I was able to more fully understand one of these complex issues: contingent liabilities.

## 1.3 Questions

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

A contingent liability is one that is not certain to occur, but simply has the potential to occur in response to some future event. Company's only record these contingent liabilities if they are both likely to occur and estimable. Examples of these contingent liabilities include but are not limited to the outcome of a pending lawsuit, a product warranty, destruction or disaster due to a natural disaster, and a damage that occurred due to a breach in contract. Due to the accounting principle of conservatism and worst-case-scenario recording, a contingent asset—described as an asset that has the possibility of arising because of a gain due to future events—will not be listed in the financial statements. Rather, companies need to disclose these contingent assets in the notes portion of the financial statements.

**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?**

BP's view of the product warranty would be one of an assurance type warranty. With an assurance type warranty, BP understands that GE Oil and Gas provides a two-year guarantee that if the telescopic joint has a defect or breaks in response to manufacturer error, they will be reimbursed for the damages that they incur in response to the warranted good. This warranty will be disclosed in the footnotes of the financial statements as a contingent asset for BP, but will not be present in the calculations of financial records. As far as GE Oil and Gas, the manufacturer will consider this warranty a contingent liability and will first judge whether the liability is both probable and estimable. If they find that the liability is indeed probable and estimable, they will record the contingent liability within their financial statements.

**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?**

According to the FASB, there are strict guidelines for accounting for contingent liabilities. Whether these liabilities are probably, reasonably possible, or remote are integral to the accounting. While not including remotely possible contingent liabilities in the financial

statements and recording reasonable possible contingent liabilities in the footnotes, probably liabilities must be recording on the financial statements and describe them in the notes. As far as amounts to be recognized, management must use historical and reasonably estimable amounts for probable liabilities in an effort to not mislead those who use financial statements for investment purposes. Furthermore, pertaining to accounting for accrued warranty costs, GAAP allows warranty issuers to estimate the cost of warranties and recognize them when the sale is made. When the sale of the item is made, the warranty expense and allowance for warranty costs are journalized. After that point in time, if a product actually requires the use of the warranty, then only the allowance for warranty costs is debited and the cash or liability account to pay for this warranty is credited.

The main difference between these two events rises from the complexity of the oil spill compared to that of the telescopic joint. If a telescopic joint break, the accounting and management of that reality is easy: we replace the joint or reimburse the customer with the agreed upon warranty terms. These costs are reasonably estimable and historical trends of broken joints could serve as a probable approximation of future broken joints. In contrast, huge events like the Deepwater Horizon oil spill are almost impossible to predict. They come about and would not be accounted for as a contingent liability for most companies due to their low-likelihood of occurrence. Furthermore, the liabilities that arise from this event are wide-spread, affect millions of people, companies, and industries; thus, the more claims for damages from the oil spill will occur than that of the broken joint.

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

The BP management must consider a multitude of contingencies in response to the Deepwater Horizon oil spill. First among these will be the potential legal losses as it pertains to the revenue losses of different industries affected by the spill. Furthermore, BP will face governmental actions and censures due to the effect that their disaster has on the land and off-shore holding of the citizens of the United States. These contingencies, while not all will be probable, must be estimated for their probability and longevity— because as seen in the Valdez spill they effects of the suits will be long-lasting.

Furthermore, there are other complicating factors as it pertains to who can be held liable for these damages. While BP was the majority owner and operator of the lease, Transocean was the rig's owner and Halliburton was involved in its operation. These multi-faceted ownership issues will come into greater experience if the U.S. Justice Department choses to sue all parties for violating the Clean Water Act and the Oil Pollution Act.

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

If I were the BP auditor, my boundary around potential losses would focus on deliberating which legal cases where reasonable and which were just fishing for a handout. If I could separate the cases that have historically been awarded to the plaintiff in other environmental disasters from the ones where the defendant has historically prevailed, I would be able to more accurately interpret how extensive legal losses and liabilities will be. People with a

footing to file a lawsuit will be those whose professions or businesses were directly affected by the event that took place on the Deepwater Horizon. These would include fishermen, beach-front residence-leasing companies, property owners who have damages, and health hazards as a direct result from the spill. These people's livelihood is directly invested in the sea-life, water condition, and attractiveness of the beach: all of which were affected by the spill. However, there are many suits that I would consider to be unreasonable. Among them are health-care suits from people whose issues are not directly related to the spill, non-beachfront shops and real-estate professionals, and non-beachfront restaurants who can receive customers and food from other sources than tourists.

## Case 9: Wendy's Company

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Tom Fowlkes



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**1.1 Executive Summary**

**1.2 What I Learned**

**1.3 Questions**

## **1.1 Executive Summary**

Throughout this case, we were able to explore the joint venture between Wendy's and Tim Horton's Incorporated (TimWen). Many of the issues that are brought forth in this case deal with Wendy's use of the equity method on their financial statements. We had to understand how the use of notes in the financial statements can bring out the full picture of the company, and the case presented a challenge of differentiating between separate ventures that Wendy's entered into that might not have been from TimWen.

## **1.2 What I learned**

In this case, I was able to see how a large international firm like Wendy's uses the construct of a joint venture to further their economic opportunities in other countries and hard to reach areas. The financial statements became more complex with this arrangement, so I was able to learn what a non-vanilla financial statement shows and doesn't show for these large organizations. Furthermore, the use of the notes and their importance in understanding the actions of the company was enlightening, and even though other corporations might not have a similar joint venture, I now know that while we brush off the notes in the financial statements in many of our introductory and intermediate accounting classes, they are of immense importance for accountants and investors.

## 1.3 Questions

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

Companies enter into joint-venture agreements with the desire to work with another company on a certain project for a certain period of time. Joint ventures offer several advantages. First, and in the case of Wendy's and TimWen, the separate entities can use the other's knowledge, geographic location, and physical assets to better infiltrate a market. Second, when the ventures are successful or when they incur losses, the separate entities get to share in the profits and in the burdens of the loss. This removes some of the risk that would be present if one company went out on their own to accomplish a task, and for this reason, joint-venture agreements are very attractive to many companies.

### **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.**

Accounting with the equity method means that the investor gets to share proportionally in the gains and losses on the investee consistent with the percentage of the investee that investor own. If a company owns 50 percent of another company, and that investee company makes \$100,000 of profit, the investor company gets to share in \$50,000 of that profit. When the investor buys stock, or equity, in the investee, the initially debit the Equity Investment account, and credit either a liability account or a cash account for what we paid for that equity. As the investee brings in subsequent income, the investor debits that same equity investment account and credits an equity income account. Finally, if dividends are declared by the investee, the investor must

credit the equity investments account because the dividend represents a lowering in the value of the investor's shares and debits cash.

**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?**

An investee company, prior to being invested in, has been amortizing and depreciating the assets on their books; however, once the investor invests their money into the investee, the investor must write up these depreciated assets on the investee's books to represent the fair value that the investor paid for the assets. The investor decides how much the assets' fair values are by receiving fair value appraisals from a third party. The excess money that the investor paid for the investee's assets, over the adjusted current fair value, is represented in the investor's books as goodwill.

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

In Investments, under assets in the balance sheet— as well as in note 8— we can see the values. In this section, they have their equity method investments in addition to the Tim Hortons information and other ventures. In 2012, the amount of equity investments is \$87,620, which is \$89,270 subtracted by \$1,750. In 2011, the amount is \$91,819, which is calculated by taking \$91,742 and adding it to \$77.

**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?**

As seen in the previous question, the December 30, 2012 investment in TimWen was \$87,620 while the equity amount that Wendy's holds in TimWen is \$35,282. This leaves a difference of \$54,088. To understand this difference, one must look at the acquisitions account premium. For reference, an acquisition premium is the difference between the estimated real value of a company and the actual price paid to obtain it.

**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 method investment employed by Wendy's for their TimWen investment affected their net operating expenses, and the value of the share of TimWen's net income can be seen by looking at the consolidated statement of operations under "other operating expenses." By employing the equity method, Wendy's adjusted their earnings for amortization from the acquisition price. In 2011, Wendy's earnings before taxes were \$10,571, and in 2012, their earnings before taxes were \$10,551.

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

Equity Investment	13,680	
	Equity Income	13,680

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

Equity Income	3,129	
	Investment in Joint venture	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.

Cash	15,274	
	Investment in Joint Venture	5,274

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

- i. The operating activities section of the cash flow 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

To reconcile this amount, the loss that is denoted from the joint venture in Japan needs to be subtracted from the earnings before taxes. This will take \$10,551 (EBT) minus \$1,827 (the loss). The negative adjustment is made to go from operating cash flows to net cash due to the fact that the earnings were first hidden within net income.

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

The reason we must make a positive adjustment to arrive at net cash from operating activity is the opposite reason we had in G-i: the cash was not originally shown within net income. Also, unlike G-i, these dividends were received in cash, and must be reconciled in a different manner than the non-cash transaction.

# Case 10: Johnson & Johnson

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Tom Fowlkes



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**1.3 Questions**

## **1.1 Executive Summary**

This case involves a study of Johnson & Johnson's pension. In the concepts portion of this case, we are able to explore how the pension is accounted for in the real world. Outside of a classroom, this case is an eye-opening experience. It requires our conceptual knowledge to be tested as well as our knowledge of financial statements. The questions lead us to a greater understanding of how the concepts apply to the accounting and how the accounting is actually practiced for pension funding.

## **1.2 What I learned**

In this study of pensions, I was able to explore how the financial statements display the funding of Johnson & Johnson's pension. A lot of the issues that are addressed in this case mirror the lessons that we have been trying to learn in Intermediate Accounting 2. The pension fund is difficult for me to understand, for the PBO and Plan Asset correlation has many different intricacies. During this case, I was able to more clearly see how a real company addresses the pension funding liabilities, and the questions in the conceptual portion of the case allowed me to reinforce my knowledge on the different accounts involved.

## 1.3 Questions

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

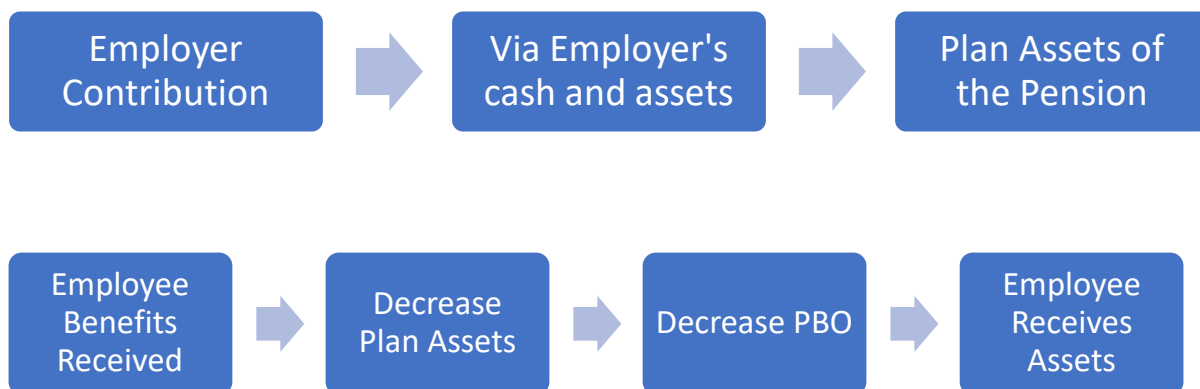
**i. How do these two types of plans differ? Which type does Johnson & Johnson have?**

A defined benefit plan puts the onus on the employers. The plan that is proposed outlines the benefits that the workers will receive at the time of their retirement, and for the remainder of their working life, the employer has to contribute varying amounts of funds to reach that goal. The defined contribution plan, on the other hand, only informs the employee what yearly contribution the employer will make. There is no guarantee to the benefits they will receive in the long-run.

**ii. Explain why retirement plan obligations are liabilities.**

Retirement plan obligations are liabilities because they represent a legal obligation to pay for services performed right now. They are based on the amount of work that the employee does, and the company is legally and most-likely contractually obligated to fund the pension plan. Therefore, the retirement plan obligations represent liabilities and future forfeiture of assets for a service performed in the present.

*Figure 10-1: Retirement plan flow chart*



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

Many of the estimates that are necessary in order to account for retirement plan obligations come from the actuarial activities performed. The actuaries must assume mortality rates, employee turnover, future salaries, and rates of return.

**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.**

1. The service cost is the increase in liabilities that corresponds to the employees' yearly work. It is the amount of funding that arises in pension obligation due to the work that the specific employee or group of employees performed
2. Interest cost is the yearly increase due to interest on the current Projected Benefit Obligation that is required so that the future value of the PBO is equal to the future cost. It arises because the PBO is discounted for time and must receive an increase in interest expense to meet the future value.
3. Actuarial gains or losses occur when risk assessors alter their view of the risk. This represents a change in valuation and projected liability for the company; thus, an actuarial assumption being changed can have far reaching consequences to the company's financials.
4. Benefits paid to retirees are the tangible checks that go out to those who are recipients of the pensions. They represent only entries in the memo side of the pension worksheet and deal mainly with PBO and Plan Asset values.

**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.**

1. Actual return on pension investments are the percentage increase or decrease that the invested pension money experiences as a result of its investment. If the investments where the money is help experience a gain or loss, so does our corresponding plan assets account.
2. Company contributions are relatively straight forward. They represent the amount of money that the company itself paid into the plan assets. The company decides on an

amount to fund for the year, and send a check to their fund manager— thereby funding the plan.

3. Benefits paid to retirees decrease the pension assets in the plan. They are a check that is written by the fund manager to the pension recipient. The recipient cashes this check and in turn reduces the amount of plan assets that are amassed in the plan.

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

The “return on plan assets” component is the expected return on plan assets. The pension expense uses the expected return to reduce market-induced volatility in the income statement. As always, the pension expense is based off the beginning year balance of the Plan assets multiplied by the expected rate (gains and losses accounts make up for the difference in actual versus expected).

**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 these other benefits and the retirement plans is funding. Johnson and Johnson does not fund retiree health care benefits in advance and has the right to modify these plans in the future, while the retirement plan is much more onerous and obligating for the company to fund and not change.

**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.**

- 1. How much pension expense did Johnson & Johnson report on its 2007 income statement?**

Pension expense is equal to \$646,000,000

- 2. Prepare the journal entry to record the service cost and interest cost portion of the 2007 pension expense. (Journal Entries in millions)**

Pension Expense	597	
	Projected Benefit Obligation	597

Pension Expense	656	
	Projected Budget Obligation	656

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

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

The retirement plan obligation as of December 31, 2007 is \$12,002,000,000. This value represents the entire accumulated pension obligation for the pension plan as a whole. It is an aggregation of all previous year's pension expenses net of the benefits already paid out. This number, as all accounting figures are supposed to be, is a conservative estimate of the budget obligation. While this figure may go up and down and is not 100 percent accurate, it is a representation of what the company believes its pension obligation would currently be valued at.

- 2. 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.**

In the year described, the interest cost is \$656,000,000, and the beginning PBO is \$11660. Also, the PSC amendments are \$14,000,000. This means that the average interest rate is 5.6 percent. This falls within the domestic and international rates disclosed in the footnotes.

- 3. 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?**

According to the Change in Benefit Obligations sheet, the company paid \$481,000,000 in benefits this year. The benefits were not paid in cash. The benefits paid reduced both the PBO and the Plan assets. It is a tangible decrease in the amount of future PBO and it is a decrease in the amount of investments that the Plan contains.

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

- 1. What is the value at December 31, 2007, of the retirement plan assets held by Johnson & Johnson's retirement plan? What "value" is this?**

Johnson & Johnson had a value of their retirement plan assets of \$10,449 million. The value represents the fair value of their investment into the plan.

- 2. 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?**

The expected return for 2006 plan assets was \$701 million while the expected return for 2007 \$809 million. For each of the years, actual return was \$966 million and \$743 million, respectively. The difference between these two numbers in 2007 is only around 8 percent: not so significant. However, the change in 2006 is around 27 percent: fairly significant. In my opinion, the actual return reflects the economics of the company better because, while this might sound dumb, it is the actual amount that they incurred.

**3. 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 to the retirement plan as a company. Its employees contributed \$62 million. Both of these payments are larger than the payments in 2006 (\$259 million and \$47 million, respectively).

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

Johnson & Johnson's retirement plan contains 67 percent equity, 32 percent debt, and 1 percent real estate/ other.

**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 plan is underfunded in both years. In 2006, it is underfunded by \$2,122 million, and in 2007, it is underfunded by \$1,533 million. This is found under the "Fund status at end of year" line— under the change in plan assets section.

# Case 11: CEASA Article

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Tom Fowlkes

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**1.3 Questions**

## 1.1 Executive Summary

Within this case, we summarize and analyze “On the Balance Sheet-based Model of Financial Reporting.” This piece, written by Professor Ilia Dichev explores the past, current, and potential future effects of the balance sheet-based model as it compares to the income statement-based model of financial reporting. The balance sheet-based method, which concludes that the proper valuation of assets and liabilities is the primary goal of accounting, has been adopted by the FASB and much of the world; however, Dichev believes that the balance sheet-based model is contradictory to the economic process of companies. He believes that earnings are the most important output of the accounting system; therefore, the income statement-based approach will provide a clearer and more useful concept to present and potential investors and creditors about the financial health of the company. Furthermore, Dichev presents the history of the two methods, how the balance sheet method became the preeminent method, and how many of the assumptions about the value provided by the balance sheet method are wrong. In my answer to the questions posed by this case, I revealed that Dichev’s article made me realize that many internally used balance sheet accounts should not be required to be represented at fair value, but I wasn’t completely convinced that the assumptions required for accrual and deferrals would be more accurate than the fair value assumptions made for balance sheet-based models on financial reporting. Finally, I stated that with this knowledge, I would attempt to help myself and others invest more wisely in corporations, could include notes in certain financial filings about different internally and externally used accounts, and shouldn’t sacrifice my duty as an accountant simply because the FASB or model states that a certain practice is acceptable.

## **1.2 What I learned**

This article was one of the more enlightening cases that I have had the pleasure to complete. It was a pertinent accounting issue that will truly affect the future of our profession and my own personal earning potential. The article itself addressed the shortcomings of the FASB-sponsored balance sheet-model of financial reporting and provided the reader with a solid alternative of the earnings-based income statement model. While there are still issues that come along with the latter model like accrual and deferral estimation, it is clear throughout this article that the earnings volatility that we have been experiencing in the recent decades, even as revenues and expenses stay constant, has to be due in part to the accounting methods that are being used. Furthermore, with the different illustrations used in the text, it was easy to see how this article will affect me in my job. I must be able to understand that my duty as an accountant cannot simply be pushed aside in favor of a certain standard: I must not be afraid to stand up for the rights on investors and voice my concern to both my company and my clients. Overall, this case provided a timely insight into the real issues affecting the accounting profession and will be very useful in my life working as an accountant.

## **1.3 Questions**

### **1. Summarize the article**

This article, entitled “On the Balance Sheet-based Model of Financial Reporting,” written by Ilija Dichev, takes a closer look at the current issues surrounding the accepted accounting norm of a Balance Sheet-based model for Financial Reporting. The article begins with a brief overview of the topics covered, and within this introduction, Dichev explains that an accounting financial report should reflect the business’ reality and essential features of that business’ model. With this

in mind, Dichev goes on to state his belief that earnings are the most important output of the accounting system, but that Balance Sheet-based model of reporting destroys the usefulness of these earnings due to the continual re-valuations of assets. At the close of the introduction, Dichev states that two things can be done to alter the current accounting issues. First, we need sharp theoretical and practical distinctions between operating and financing type activities and assets, and second, accounting for operating activities needs to have a renewed emphasis on the matching principle and revenue recognition principle. Dichev then gives the reader background to the argument, states his critiques on the current model, and finally proposes to the reader some alternative approaches that could be taken.

Within Dichev's history lesson, we learn that in the past few decades, there has been a conversation between the FASB and the IASB about the reassessment of the foundational accounting concepts like assets liabilities and revenue recognition, but Dichev believes that without reconsidering the balance sheet-based approach, there will be costly financial. Only through integration of the income statement approach can we avoid some of these consequences. Thus, Dichev proceeds to explain the context of this issue. The balance sheet approach's primary goal is proper valuation of assets and liabilities; thus, the determination of assets and liabilities determines the earnings— earnings being equal to change in net assets over that period adjusted for distributions and contributions. In contrast, the income statement- based approach's primary goal is determining the revenues, expenses, and earnings of the company; thus, the balance sheet accounts are residual to this process and the assets and liabilities are the cumulative effect of, as Dichev puts it, "periodic accruals." Historically, the income statement method has been dominant, but as the FASB overtook the part-time, understaffed APB, they made a shift towards solely focusing on the balance sheet approach, for the FASB believed that "earnings is a change

in value concept, and it is impossible to define a change in value concept before one defines what value is.” In other words, the FASB took this position because they believed that assets and liabilities precede and supersede the determination of earnings. As this decision moved abroad, the IASB and the FASB have doubled down on their dedication to the balance sheet approach, and through the Norwalk Agreement, they will concentrate on ironing out the inconsistencies between the two bodies— with strong endorsement of the balance sheet approach from all sides.

Dichev informs the reader of this history, and then he begins to criticize the balance sheet-based model of financial reporting. He states that this approach is at odds with how most businesses operate, create value, and are managed. Most assets, Dichev states, are just supplementary and temporary devices. They are props that serve the continual stream of company operations and have little independent existing value. If firms were asset greenhouses, Dichev continues, then the balance sheet method would make sense, but because they are asset furnaces, where the assets are acquired and sacrificed for larger goal of producing revenue, the balance sheet method doesn't fit the goal of the company and makes an illusion that assets are growing and eternal. It is evident that managers want to project revenue and expenses first and then understand the assets they need to achieve these numbers after. Through the use of an illustration, Dichev reveals that while only a small portion of the PPE of a company— named Compustat—is used for external processes, the market value of the PPE is used to value its contents. Thus, even though the fair value is irrelevant for ninety-eight to ninety-nine percent of all the PPE assets, the balance sheet method requires it to be tracked in this way. He finishes this portion of the article by stating that the dividing line between income statement and balance sheet-oriented models seems to be the distinction between operating and financing activities.



Continuing his criticism of the balance sheet method of financial reporting, Dichev challenges the conceptual superiority of the balance sheet approach. The reason the FASB thinks it is superior is because, as stated earlier, you cannot define change in value before establishing what value is. However, the definition of an asset is the “probable future economic benefit obtained or controlled by a particular entity as result of past transactions or events;” therefore, the concept of an asset and income are inextricably linked. If someone has an asset, Dichev states that there is a stream of income attached to it, or it would not be an asset. Moreover, the shift to more capital tied into human capital, intangibles, goodwill, or monopoly positions, reveals that many accounting issues cannot be accurately represented through the balance sheet concept.

Following this critique of the balance sheet model, Dichev seeks to prove that the method itself is causing the recent decline in “forward-looking usefulness of earnings.” To investors, recurring earnings are the most essential part of the future stream of earnings, but in the balance sheet approach, assets are seen as a store of value and earnings are seen as a change in net assets: a fact that implies low persistence and low predictability of earnings. While the FASB has been pushing this approach, earnings volatility has doubled and earnings persistence has fallen. Even as underlying revenues and expenses and cash flows have remained constant, the earnings have changed wildly: a trend that suggests accounting errors play a role. Dichev thinks that this occurs because the balance sheet approach mandates various asset revaluations, which result in an increasing number and magnitude of write-offs, or one-time changes.

Finally, Dichev gives the reader a suggestion about what a “better” conceptual framework might look like. First, he suggests that since operating activities include all activities which are related to regular business of the company, we need the income statement approach to clearly identify the difference between earnings from regular operating activities, which have a

lot of persistence and forward looking informativeness, and the earnings that are due to fair value fluctuation in financial assets, which have little persistence and predictive power. Through grouping the incomes separately, investors and companies will be able to understand the true earnings of a company. Secondly, there must be a renewed interest in the matching principle and revenue recognition principle. Since most businesses are run on the explicit or implicit logic of matching costs and benefits, the realignment will more closely match the actual leadership that the company employs. Dichev then proceeds to restate his overarching thoughts on the issue and conclude the article.

## **2. How did reading this article change your current way of thinking?**

This article challenged my thinking about this topic; however, I do not believe that my mind has been made up that the income statement method of financial reporting is superior to the balance sheet method. Yes, it is true that companies do not operate or create value in the ways that the balance sheet values the company, but the revenue recognition principle and matching principles involve a much larger group of assumptions than does the valuation of the assets of a company at the fair value. Even if arbitrage opportunities are still available and bubbles still exist because we put so much faith in the market value, I think it is much more prudent to value this number than that of one manager in one company who recognizes his revenues and anticipates his liabilities unilaterally.

While I have my doubts, Dichev's views did truly affect me. When it came to the "asset greenhouse" illustration, I was able to see that we do indeed treat all assets currently like they are the basis of our company's valuation, but they are, for most companies, simply a means to an end for generating revenue. They do not represent, especially when you consider the Compustat illustration, an accurate valuation of what will be used to create future revenues. If it is true that

firms operate to generate revenues through their expenses, then assets truly have a secondary and supporting role in the process. Nevertheless, the assets that are owned by the firm do give a sense of how much capital has been invested in the firm. When Dichev states, “the balance sheet model takes asset values as given, as stores of values, which are divorced from what the firm is doing and diverts attention from operations which are the key to firm focus and value,” I understood more fully how the balance sheet model hides and distorts the true earnings potential that the firm holds. Without a focus on accurate earnings, which is what many investors use to calculate EPS and other rudimentary valuation tools, the entire accounting profession is primed for disruption.

If the accounting profession does not act on this issue in some capacity, I think that it might face many of the same issues that the legal profession is dealing with right now. That profession required vast amounts of inefficient human capital to get a job done, but now, the technology and ease of access has diminished the legal profession’s utility to society. Will accounting be the next profession to lose its credibility and worth to society? If the concept of assets and income are as inextricably linked as Dichev states, and the earnings predictions have been as useless as it seems, I argue that the accounting profession must reconsider its path to achieving the goal of informing present and prospective investors and creditors on the financial environment within the company.

**3. How will you use this information in your future career? Be thoughtful and creative about the situations you will encounter where this article will affect your beliefs and the way you carry out your future job.**

The first way I will use this information is in my personal investing. Accounting professional or not, we all must be aware of how we invest our money, but we also must realize how the companies in which we invest use their assets. Are they being valued over an above their actual earnings potential or, like Microsoft, do they have non-balance sheet assets that will drive revenue in the future? While this does not directly correlate to my future job, it will affect how I appraise companies in my personal investing, and it might help me if I ever attempt to bring in new clients to my accounting firm. Just like Enron's mark to model issues mentioned in this article, I must be watchful not to sacrifice profitability and a paycheck for my honor and duties as an accountant. If I know and am aware of serious discrepancies in the books of my client, I cannot simply brush it off as a product of the financial statement model we are using to evaluate the books: especially if there is open corruption within one of my client's leadership team.

Secondly, when it comes to the accounting profession's recent trend towards a ubiquitous fair value measurement for all balance sheet accounts, I believe that this article has altered my views concerning the issue. I do not believe that some accounts, such as those in PPE that are used for internal uses only, deserve or need to be valued at some arbitrary market-based number. Other than in times of liquidation, the fair value of purely internal accounts does not help our accounting firm achieve its goal of accurately portraying the value of the company to investors or creditors. Furthermore, I think that Dichev's solutions to the issue are founded on strong

reason. Following my aforementioned desire to be more careful about ubiquitous fair value measures, the balance sheet could more accurately represent the value of the company if there were separate bottom lines for internal and external assets. While I do not have the expertise in this sector when it comes to actual time on the job, I do see value in reporting to investors and creditors the different bases of value that a company has. If the assets the company hold will not be tied directly an outside buyer or seller, then why are they measured at fair market value? Thus, I will advise my clients and my co-workers to include within the notes page an overview of how the different assets within the balance sheet are used and why each portion is measured at fair value. That way, even if it goes above and beyond the requirements of the FASB, I will be providing a service to the true victims of this mistake: average people and uninformed investors.

# Case 12: Google Inc.

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Tom Fowlkes

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## **1.1 Executive Summary**

This case takes us through Google's balance sheet, income statement, consolidated financial statements, Non-GAAP presentations, and stock price reactions. In the presentation of net income, Google presents a GAAP value and an alternative Non-GAAP value. Because of the disagreements that companies retain about the recent GAAP changes concerning stock-based compensation, restructuring expenses, and the income taxes associated with the two, a trend in reporting has emerged that presents a Non-GAAP income statement that excludes those expenses and many others. In this case, we look at the comparison between the two figures and seek to understand what is driving their differences. Next, as we focused on the reaction of stock price to earnings report, the case inquired as to the market's response to good and bad news in these aforementioned reports. Finally, after reading the Wall Street Journal analysis on Google's stock price, we reported on whether the analysts' predictions were true and what the predictions themselves contained.

## **1.2 What I learned**

This case pushed me to do outside research on the reason why Non-GAAP figures exist in financial reporting, and why, even at a risk to stockholder understanding, companies insist on presenting them. As I understand the issue, it seems that GAAP's rulings to include SBC expenses and restructuring expenses are challenged by companies because they (the companies), do not believe that non-monetary expenses like SBC should affect net income and unusual charges like restructuring expenses should either. Furthermore, as it pertains to the effect of earnings releases on stock prices, I was able to see that good, bad, or neutral, the quarterly earnings reports do have significant effect on the company's market value and stock price. As we see in the Wall Street Journal article, much is made of every quarterly report, so companies like



google must give intense focus and effort to succeed and reach goals every quarter. Finally, within the WSJ article, there where points raised about the streamlining of Google's business by selling Motorola that I had never thought of before, namely, the fact that shifting away from one of your core businesses, like Google shifted away from Android, is not always negatively received by the investing community.

## 1.3 Questions

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

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

The reason that non-GAAP net income and the GAAP net income are different come from a variety of accounts. The differences between these two can be attributed to the Non-GAAP net income’s elimination of the stock-based compensation expense account and its related tax expense as well as the elimination of the restructuring expenses and its related income tax expense. I agree with Google’s actions, for I think that the required SBC reporting unnecessarily depresses income from the income statement and doesn’t reflect the actual financial climate of the firm. While GAAP has its reasons for including the expense, I think that Google is well within its rights to present a Non-GAAP number

with SBC excluded. Furthermore, as far as restructuring charges go, I think that this account has less of a standing to be excluded from the financial statements. I think that restructuring, while definitely not part of the normal business, can be more repetitive and actually costly than SBC issues. Therefore, I disagree with Google using the exclusion of the restructuring expenses to calculate Non-GAAP net income.

**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.**

Over 2013, Google's stock price clearly responded to earnings reports. Whether good or bad, it is evident that the stock price closely watches the reports when they come out. While Q1 response isn't as drastic as Q3, there is a sharp decline and rebound right around the earnings report: suggesting some fear about what the report would contain. In Q2, there didn't seem to be any drastic response to the report, but in Q3, there was a huge spike in price when the earnings were announced. Finally, in Q4, there was a brief spike followed by a leveling out.

- 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).**

All companies experienced the same pre-Q1 dip and recover, but Google's performance compared to other NASDAQ stocks during the Q2 release was negative while the other

stocks trended upwards in value. In the Q3 report, Google clearly outpaced the NASDAQ stocks and continues to be valued higher than the index itself due to that large spike. The Q4 report did not seem to deviate much from the movement of the rest of the index, but Google's stock remained more valuable.

- 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.**

The market perceived the earnings news in Google's press release as bad news in the short run but not a detrimental report. The price dropped in the days immediately following the report but rebounded to pre-report levels shortly afterward.

**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?**

Yes, these relations seem to reflect what the forecasters predicted. While there was an immediate frustration with the \$12.01 EPS that fell \$.19 short of predictions, the investors did seem to follow the predictions of investing in Google as they streamlined their processes by selling off Motorola. Furthermore, as ad revenue was rising and clicks were increasing, the analysts predicted correctly that investors would be optimistic

about the company's shift to mobile-based ads rather than more traditional computer based, more pricey ads.

- ii. What other factors does the article discuss that might contribute to the market's positive reaction to the earnings press release? Are there any factors that might cause investors to be concerned about Google's recent performance?**

The other factors that the article discusses centers around the selling of Motorola, the reduced per click payment of ad revenue, the shift to mobile-based ad revenue, and the lower than predicted EPS. While the EPS is depressing, the belief that the company was becoming leaner and more reconnected to its goal of investing heavily into computers and data centers. The only downside we could see addressed by the analysts was the two billion dollars in losses the company had suffered due to the smartphone unit. Also, the shift to cheaper mobile advertisements, while still steadily earning currently, could come back to harm Google due to its relatively small revenue stream in comparison to the older computer-based advertisements.

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